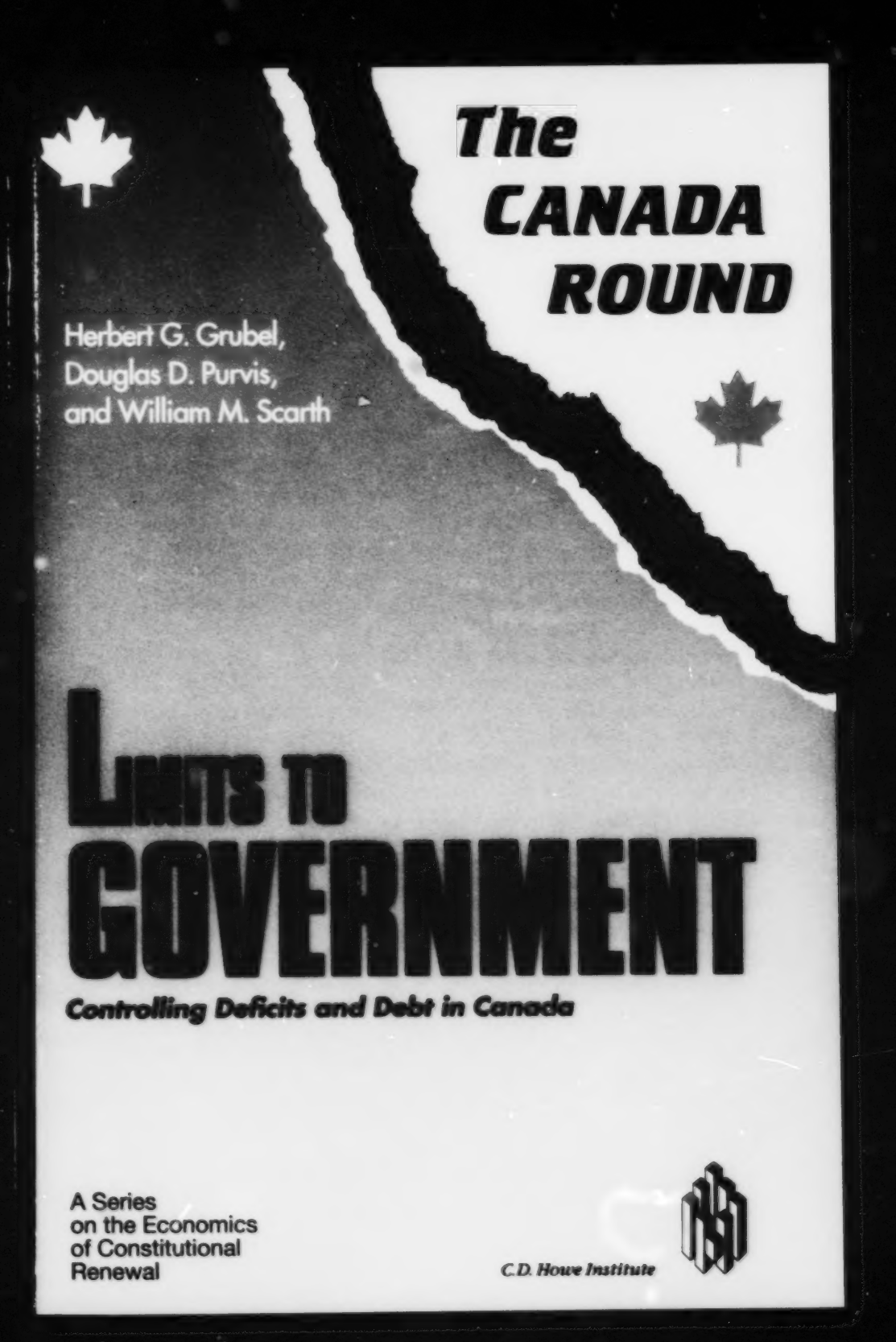

Herbert G. Grubel,
Douglas D. Purvis,
and William M. Scarth

LIMITS TO GOVERNMENT

Controlling Deficits and Debt in Canada

A Series
on the Economics
of Constitutional
Renewal

C.D. Howe Institute

C.D. Howe Institute

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Limits to Government:

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Herbert G. Grubel,
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and
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The Canada Round:
A Series on the Economics of Constitutional Renewal — No. 13

John McCallum, Series Editor

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Foreword

Canada appears poised to embark on an historic political reconfiguration. It is essential that this process be undertaken with a clear and widely diffused understanding of the well-spring of Canadians' economic prosperity.

It is with that in mind that the C.D. Howe Institute presents this series of monographs entitled *The Canada Round*. The series assembles the work of many of Canada's leading economic and political analysts. The monographs are organized into two groups. The first group, called "The Economics of Constitutional Renewal," rests on the assumption of renewed federalism and is organized around economic themes. It examines the economic goals that Canadians have set for themselves, as well as the means of achieving them and the influence of alternative constitutional structures.

The second group of studies, called "The Economics of the Breakup of Confederation," examines the economic consequences of Quebec independence for both Quebec and the rest of Canada. A unique feature of the "Breakup" studies is that they are integrated with the research that has already been carried out by Quebec's Bélanger-Campeau Commission. Where appropriate, each of the studies in this group includes a summary of the relevant analysis by the Bélanger-Campeau Commission, contributions by experts from across Canada, as well as shorter critiques or replies. This format, we believe, will help to pierce Canada's "several solitudes" and create a pan-Canadian meeting of minds.

The Canada Round is not intended to alarm or frighten — the process of collective political definition in this country will turn on more than simply questions of dollars and cents. And, as these monographs will reveal, economics rarely produces an open-and-shut case as to the superiority of one possible set of rules over another. Even if it could do this, it would be unwise to assume that

economic analysis alone could change the minds of those who are already committed to a particular vision of the political future.

It is equally clear, however, that Canadians are now seeking a greater understanding of the links between the economy, the Constitution, and legal and political life. A significant reform of the Constitution will influence the economy, in some cases for the better; a rending of the Constitution under conditions of acrimony will almost certainly damage it. Thus, the purpose of the series is to help Canadians think constructively about the benefits and costs of alternative constitutional designs.

Underlying the series is a focus on the economic well-being of Canadians, now and in the future. To best insure this well-being over the short run, Canada needs calm, open negotiations in which efforts are made to understand and incorporate the aspirations of all the participants. This series of monographs is dedicated to that effort.

John McCallum, the series editor and Chairman of the Department of Economics at McGill University, organized the intellectual input. Within the C.D. Howe Institute, David Brown, Senior Policy Analyst, played a coordinating role. This thirteenth monograph in the series was copy edited by Margaret Hoogeveen, Darlene Zeleney, and Barry A. Norris, and desktop published by Brenda Palmer. As with all C.D. Howe Institute publications, the analysis and views presented here are the responsibility of the authors and do not necessarily reflect the opinions of the Institute's members or Board of Directors.

Thomas E. Kierans
President and
Chief Executive Officer

The Study in Brief

In his contribution to this volume in "The Canada Round," Herbert Grubel argues for constitutional limitations on the deficits and spending of the federal and provincial governments. Violation of these rules would automatically trigger the dissolution of the legislature and the calling of an election.

Grubel argues that tough constitutional spending limits are needed to curb the power of special-interest groups. The power of these groups has been increasing, partly because of technological innovations that have reduced the cost of organization and political lobbying. The result has been a rising trend of government spending, much of which is wasteful and inefficient. Moreover, sustained deficits crowd out private spending, and they require ever-rising rates of taxation. Both of these effects reduce economic growth and impose a burden on future generations.

More fundamentally, Grubel argues, constitutional limits are needed to protect the rights of Canadians to the fruits of their labor and capital, and also to reduce the threat to democracy that arises from excessive spending and deficits. In addition, firm limitations on deficits and spending would contribute to national unity, since there is a widespread perception in Quebec that federal spending and deficits are out of control. The constitutional crisis has opened a window of opportunity, Grubel says. We should take advantage of it.

Grubel acknowledges that there are many technical problems involved in implementing his proposal. He discusses some of these problems, as well as the experience of U.S. states, and concludes that the difficulties, costs, and risks associated with his proposal are smaller than the likely benefits.

Whereas Grubel is concerned with long-run debt and deficit control, William Scarth focuses mainly on short-run stabilization policy. He argues that provincial stabilization policy operating

through changes in government spending is likely to have a "beggar-thy-neighbor" effect. An increase in provincial government spending in, say, Ontario, will stimulate the Ontario economy, but it will also depress the economy of the rest of the country. This is because Ontario's fiscal expansion will lead to higher interest rates across the country and to a high Canadian dollar. As long as the Canadian business cycle is more or less synchronized across provinces, this "negative spillover" effect will be damaging to other provinces and to the country as a whole.

Scarth suggests two ways to avoid this problem. One possibility would be to fix the value of the Canadian dollar in terms of U.S. dollars. In this case, the problem would be solved because, Scarth shows, the negative spillovers would become positive spillovers. Another possibility would be for provinces to conduct stabilization policy through temporary changes in sales taxes, rather than through changes in government spending. Again, Scarth shows, the negative spillovers are likely to become positive spillovers, in which case countercyclical provincial fiscal policies will tend to reinforce each other, rather than cancel each other out. On the other hand, Scarth acknowledges that "sanctioning stabilization policy at the provincial level may make it more difficult to keep the country's policymakers focused on the long-run deficit dynamics."

Douglas Purvis comments on the two papers. He argues that Scarth's analysis of spillovers underscores the need for fiscal policy *coordination*. This would involve intergovernmental collaboration, possibly acting through a new institution such as the proposed Council of the Federation. While acknowledging that Grubel provides a great deal of food for thought, Purvis finds his argument to be overstated and unsubstantiated in a number of areas. On a more positive note, he argues that the political process may contain self-correcting mechanisms that come into play when deficits and debt levels become excessive. If this is so, we may see the stabilization of government debt ratios in the years to come.

John McCallum
Series Editor

Constitutional Limits on Government Spending Deficits and Levels in Canada

Herbert G. Grubel

Introduction

In this essay I propose a bold but sensible course of action: that Canada's federal and provincial governments enshrine restrictions on government spending deficits and levels in their respective constitutions. A violation of the requirements would automatically invoke dissolution of the legislature concerned and require an immediate election. Although severe in nature, I believe this proposal is absolutely necessary. It is motivated primarily by the postwar growth of spending and by the large fiscal imbalances that have existed since the mid-1970s. In my view, these developments deprive Canadians of their economic rights and threaten the stability of the economy and possibly the future of democracy in Canada.

If given substance, this proposal will eliminate excessive spending levels and deficits, thus protecting the economic right of Canadians, that is, the right to enjoy the fruits of their labor and investments and also eradicating a potential threat to the democratic system of government in Canada. The growth of spending in recent years has reduced the income of Canadians because it is wasteful and hence effectively decreases the efficiency of the economy.

I gratefully acknowledge the useful comments on the first draft made by Irene Ip, David Keating, John McCallum, and participants at a seminar at Simon Fraser University in March 1991. I am also grateful for the valuable insights provided by James Buchanan and James Davidson concerning the movement for constitutional spending limitations in the United States. The National Taxpayers Union of Washington graciously supplied me with relevant literature.

My second motive for writing this proposal is that it would invalidate federal fiscal mismanagement as a justification for Quebec independence, as recently argued by Pierre Fortin.[1] The adoption of constitutional spending restraints would destroy this argument, thereby assisting Canada in its search for unity.

The third motivation for this proposal is that the restraints would eliminate the need for cooperation and harmonization of fiscal policies between the federal and provincial governments. The institutionalization of such a system, which the federal government proposed in the fall of 1991, may be expected to meet much resistance from provincial governments reluctant to surrender any of their fiscal sovereignty to a central authority. However, the constitutional spending restraints I suggest for both levels of government would effectively eliminate the need for such controversial coordination.

The imposition of constitutional restraints on the fiscal freedom of a democratically elected government involves a fundamental change in the nature of parliamentary democracy, which requires careful consideration and justification. The first part of this essay provides such a review at the level of the philosophy of government and the nature of democracy. The second section places the justification for restraints into the context of the recent problems of the federal government, which I see to be the seemingly intractable propensity to engage in deficit spending and the growth of spending as a percentage of national income.

I argue, further, that these developments imply a growing inefficiency in the allocation of resources and a reduction in the rate of economic growth. Spending deficits crowd out private investment and require ever-increasing rates of taxation. Reduction in private income without corresponding improvement in the supply of public goods and income distribution is a blatant violation of the fundamental economic right to the enjoyment of the returns from one's economic activity. In addition, there is the risk that this development

1 Pierre Fortin, "Quebec's Forced Choice" (Remarks prepared for the Conference on the Future of Quebec and Canada, Faculty of Law, McGill University, November 16–18, 1990).

threatens the very existence of traditional democratic institutions. The incomes and rights of future generations are thus violated as well.

The growth of overall government spending and the persistence of deficits results from the actions of unconscionable politicians who cater to powerful special-interest groups for the purpose of obtaining their support in upcoming elections. The power of these groups, and that of the bureaucracy, is a consequence of largely irreversible changes in the technological environment, which have lowered the costs of organization and political lobbying. This power can be controlled only through changes in the rules of the game governing the behavior of Parliament: the Constitution. By imposing on legislators a budget constraint, and thereby limiting the funds available for distribution, legislators cannot be tempted to dole out the dough to every group that asks.

Subsequent sections of this study present specific proposals for restraint provisions and discuss general problems encountered in their design. Problems of implementation are serious but not insuperable. The discussion of these problems, as well as the existence and successful operation of such restraints in many U.S. states, suggests that the benefits far outweigh the difficulties, costs, and risks involved.

Quebec's demands for more power and the consequent federal government proposals for the revision of the Constitution have opened a window of opportunity for the inclusion of spending restraints in this document. Let us hope that Canadians will make use of this occasion to protect their future.

The Role of Constitutional Restraints in Democracies

Proponents of constitutional limitations on government must address one fundamental issue: Why do democratically elected governments require such severe limits on their freedom to govern? After all, according to conventional wisdom, Parliament is supreme, serves the general well-being by enacting legislation that raises the operating efficiency of a free enterprise economy, and thus reflects

the will of the people. Furthermore, if Parliament enacts laws of which the majority of the public disapproves, including laws that result in excessively high levels of spending and deficits, the democratic election process assures voters the ability to express their dissatisfaction at the ballot box. Through their votes, citizens can elect a new government that will do away with the offending legislation. Sadly, the democratic process does not function as effectively as conventional wisdom would have it. As I outline below, the game must be given parameters.

The Protection of Fundamental Rights, Minorities, and the System of Democracy

The justification of constitutional limits on parliamentary supremacy involves profound issues about the nature of humanity and the purposes and actual functioning of government. These issues were widely discussed in Canada during the 1970s, shortly before the Constitution was patriated and the Charter of Rights and Freedoms was enacted.

In a nutshell, the argument for general constitutional restraints on the government in power is that we need to ensure that it does not encroach on the fundamental rights of human beings, that the minority is protected from exploitation by the majority, and that the democratic system will not be threatened by policies that endanger its very existence. The argument gains strength from a recent change in public perception of government and bureaucracies. According to this view, politicians and bureaucrats alike serve not the public interest but their own.[2]

2 For the first studies of these issues, see James Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (Ann Arbor: University of Michigan Press, 1962); and William Niskanen, *Bureaucracy and Representative Government* (Chicago: Aldine-Atherton, 1971). Scholarly reviews of a wider range of arguments in support of constitutional spending restraints are contained in Aaron B. Wildavsky, *How to Limit Government Spending* (Berkeley: University of California Press, 1980); and Advisory Commission on Intergovernmental Relations, *Fiscal Discipline in the Federal System: National Reform and the Experience of the States* (Washington, D.C., July 1987).

The need to protect fundamental human rights and the need to prevent the exploitation of the minority by the majority have been recognized and justified most eloquently by the fathers of the U.S. Constitution. They argued that, without such protection, the quality of life of the governed would be destroyed by the slow but cumulative effects of laws restricting fundamental human rights and freedoms. Each of these laws would be adopted by simple legislative majorities, justified by the political and economic problems of the moment, and would be seen to be correct in the light of the ideological preconceptions of the party in power. To protect against such a process, the U.S. Constitution prohibits Congress from "passing any laws which...infringe the freedom of speech" or deny citizens the right to receive a fair trial, to own private property, or to bear arms. Most modern governments of the world are restrained by such constitutional clauses. The Canadian Charter of Rights and Freedoms, for instance, restricts Parliament similarly, except that private property rights and the right to bear arms are not included.[3]

The third justification for constitutional restraints on legislatures is that they protect the democratic system from demagogues and dictators. Autocratic regimes throughout history, but particularly in seventeenth- and eighteenth-century Europe, stayed in power by suppressing both dissent and political opposition. They did so by censorship of speech and publications and by jailing citizens without trial, all of which could have been outlawed by the presence of the appropriate restraints in a respected constitution.[4] In the next section

3 The proposals for constitutional reform launched by the federal government in the fall of 1991 include a short reference to the possible enshrinement of private property rights. In Herbert Grubel, "Reflections on a Bill of Economic Rights," *Canadian Public Policy* 8 (Winter, 1982): 57–68, I argue the merit of such a constitutional clause and consider it to be part of a "Bill of Economic Rights," which includes protection against the burden of public debt payments and excessive levels of spending. The need for such a broad Bill of Economic Rights is increased by the existence of the Charter of Rights and Freedoms and the proposed creation of a Bill of Social Rights.

4 Thus, the constitutional right of Americans to bear arms, which in recent years has aroused so much controversy because of the high rate of homicides using firearms. The Fathers of the Constitution believed that this right would facilitate popular uprisings against autocratic governments and would thereby protect democracy against the possible development of dictatorial governments.

I argue that we must protect our democratic system from the threat of destruction posed by excessive spending and deficits. I believe this menace represents one of the most important arguments in favor of constitutional limitations.

The constitutions of many countries contain provisions that permit those constitutions to be amended to reflect changing economic, technical, and social conditions.[5] Efforts by Canada's federal government to add such provisions have opened a window of opportunity for including financial restrictions.[6] The adoption of formal amendment procedures will mean that constitutional spending restraints can also be changed. Nevertheless, the merit of constitutional restrictions is that they are more difficult to change than mere statutes. The resulting process permits the opinions of minor-

5 Constitutions define the rules of the game by which politics is played. Changes in these rules in response to technological innovations are analogous to changes in the rules of ordinary games of sport and entertainment in response to shifts in the particulars of the games, as when racing cars become too fast or when insufficient excitement is created by rules limiting goal scores.

6 The U.S. Constitution can be amended by a constitutional convention. Such a convention can be called by either of two methods: by a majority vote of two-thirds of both houses of Congress, or by a call from two-thirds of the state legislatures, or 34 of the present 50. Constitutional amendments proposed by a convention called by either method must be ratified by the legislatures of at least three-quarters of the states, or 38, before becoming law.

The writers of rules for the rewriting of constitutions must carefully balance the need for periodic reviews and revisions, and the consequent loss of continuity in the rules, which would damage legislative efficiency if constitutional reforms took place too often.

The same balancing act is required in writing the conditions under which constitutions would permit states or provinces to opt out of a federation. On the one hand, it is necessary to prevent provinces from opting out and then renegotiating terms whenever they can benefit individually, as Alberta might have been tempted to do after the increase in the world prices of energy during the 1970s. On the other hand, the ability of provinces to opt out by a well-defined process tends to limit the tendency of the central government to usurp power, and thus preserves the union.

For this reason, it might be useful to permit independence of a Canadian province after two popular referendums held at a two-year interval and after approval by about 60 percent of eligible voters. If such a rule had existed in the Canadian Constitution, much of the crises of recent years, which came about because of some Quebecers' demands for the independence of Quebec, could have been prevented.

ities and general concerns about long-run consequences to have more influence on changes before they are enacted, especially in contrast to the short-run considerations of politicians, which currently dominate spending decisions.

Precedents in the Use of Constitutional Fiscal Restraints

In my view, it is important that all proposals for institutional and legal changes be examined not only in the light of the kind of fundamental principles discussed in the preceding section, but also in the light of historic precedent. For this reason, I will consider briefly the nature and performance of fiscal restraint clauses in existing constitutions.

The U.S. Constitution contains no restraints on spending levels and deficits.[7] However, the constitutions of 49 U.S. states limit deficit spending and ten limit taxes and expenditures. In addition, as of January 1990, 12 states had statutory limits on taxes and spending.

---

7 The absence of such a clause has an interesting explanation, which has been given to me by James Davidson. Thomas Jefferson as the U.S. ambassador to France, observing the fiscal irresponsibility of the French court, had written to his colleagues from France about the merit of constitutional restraints. However, at the time that the U.S. Constitution was written, financial markets and the absence of a central monetary authority had made it seem impossible for the government to incur large spending deficits. The obligations of the government at that time were selling at 15 percent of their nominal value.

According to Wildavsky (*How to Limit Government Spending*, p. 45), James Madison noted in the Federalist papers the importance of special-interest groups in the functioning of democracy, though he did remark on the danger of having small interest groups gain too much influence. However, Madison believed that the large geographic size of the United States would raise the cost of organization for small groups and that, as a result, only large ones could organize. Their size would assure that the influence an interest group could exert on legislation would reflect a common, shared opinion of a sizable portion of the population. Accordingly, there was no need to be concerned about the implications of modern public choice theory. The prohibitive costs prevented small groups from obtaining legislation favoring them at the expense of the general public. Nor could the collective effect of small interest groups increase spending substantially or block tax increases needed to balance the budget.

The restraint provisions vary greatly in detail from state to state, making some more effective than others. For example, the effectiveness of restraint depends largely on whether school district budgets are part of a state's accounting system or if each school district can float its own obligations. Some differences depend on whether capital expenditures are included in the spending limits or not.[8]

It is interesting to note that restraints in U.S. state constitutions did not exist until the mid-nineteenth century. They were introduced at that time because the depression of 1837 had forced many states into bankruptcy. Limitations on either taxation or spending were adopted by a substantial number of states between 1970 and 1985, largely in response to the rapid growth in state expenditures during this period.[9] The history of U.S. state spending limitations suggests that severe financial crises of governments or excessively rapid growth in spending can provide the stimulus needed for the enact-

Note 7 - cont'd.

The growth of government spending during the postwar years and the persistence of deficits since the 1970s prompted the creation of several nonprofit organizations that have lobbied for the convocation of an assembly to propose limits on spending levels and imbalances in the U.S. Constitution.

The efforts of these organizations and other parties resulted in a vote in the House of Representatives on July 17, 1990, whereby 279 members voted in favor and 150 against a balanced-budget amendment, just seven votes short of the two-thirds majority required for passage. In 1990, 32 of the 34 states required to force the convention of a constitutional assembly had called for such an action. Political observers believe that Congress will pass a balanced-budget amendment once it becomes clear that the state legislatures can muster the votes for the creation of a constitution-writing assembly; Congress would rather not face the risk that such an assembly would extend its agenda into risky and uncharted territory.

8 Detailed descriptions of the U.S. state limitations are found in Advisory Commission on Intergovernmental Relations, *Fiscal Discipline in the Federal System*; and Connecticut Public Expenditure Council, *Tax and Spending Limitations for Connecticut: Needed Discipline or Excessive Constraint?*, Public Policy Report, vol. 2 (December 1990).

9 Naomi Caiden, "Problems in Implementing Government Expenditure Limitations," Appendix C, in Wildavsky, *How to Limit Government Spending*, contains a review of the history of state limitations on levels of deficits and spending with relevant references to the literature up to the late 1970s. There is some evidence that the economic performance of states is a positive function of the strength of the constitutional limits on spending deficits and levels.

ment of constitutional restraints. In the next section, I argue that, on these grounds, conditions are now right for the enactment of such restraints in Canada.[10]

The Dangers of High Deficits and Spending Levels

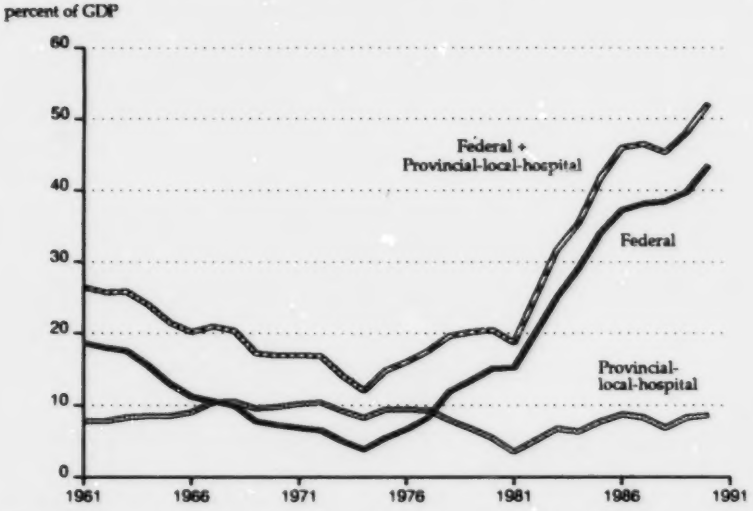
In this brief review of the recent Canadian history of deficits, the debt, and spending levels, I argue that the existing and prospective deficits and spending levels directly cause reductions in income, general welfare, and the rate of economic growth. They do so by discouraging work and investment, encouraging emigration and capital flight, creating social tensions, and threatening personal liberties. As a result of these developments, society at large suffers both currently and in the future. In addition, high spending levels increase the risk of economic and social upheavals, the consequences of which are hard to predict but sure to be both far-reaching and disconcerting.

High Deficit and Debt Levels

Figure 1 illustrates the development of the net debt of the federal government and of the provincial and municipal governments and hospital boards of Canada between 1961 and 1990. The debt, of course, represents the cumulative effect of spending imbalances, rising and falling as a result of deficits and surpluses, respectively. Debt is expressed here as a percent of national income, or gross

10 Proposals for the creation of a Federation of European States within a decade or so are now being discussed widely. A common constitution will have to be written and adopted by all member states. This prospect has prompted Buchanan and Bernholz to propose the inclusion of spending restraints in the new constitution, as can be seen in James Buchanan, "Europe's Constitutional Opportunity" (manuscript, Center for the Study of Public Choice, George Mason University, Fairfax, Va., 1990); and Peter Bernholz, "Institutional Aspects of the European Integration," in Herbert Grubel and Silvio Borner, eds., *The European Community after 1992: Perspectives from the Outside* (Houndsmill: MacMillan, 1991).

Figure 1: ***The Evolution of the Government Sector's Net Debt, 1961–90***



Note: Data are on a National Accounts basis.

Source: Canada, *Canadian Federalism and Economic Union: Partnership for Prosperity* (Ottawa: Supply and Services Canada, 1991), p. 32.

domestic product (GDP), in order to facilitate economic interpretation of the data.[11]

11 The discussion in this section uses the definition of debt found in Canada, *Canadian Federalism and Economic Union: Partnership for Prosperity* (Ottawa: Supply and Services Canada, 1991) — that is, net debt, or gross debt minus government assets. This section also assumes a national accounts basis rather than flow of funds. There are important differences in the levels and rates of growth of debt according to which definition is used. However, discussion of these differences goes beyond the scope of this essay. Basically, the growth rates and implicit size of deficits are much the same by all definitions.

Strictly speaking, the debt, as a percentage of GDP, falls if the growth rate of the deficit is less than the growth rate of nominal GDP. For this reason, the growth rate of nominal debt and therefore the absolute size of the annual imbalances are understated by the figures shown. Especially between 1961 and the mid-1970s, the decrease in the debt as a percent of GDP was caused mostly through growth in GDP. Thus, during the 1961–74 period, the value of the net debt rose from $13 billion to $25 billion, even though it fell from 18 to 5 percent of GDP, as Figure 1 shows.

A Short History of Canada's Debt

A few comments will help put these figures into perspective. First, the collective net debt of the provincial and local governments and hospital boards generally remained at a constant level throughout the period examined.[12] This trend will not likely hold up in the near future because, as of 1991, large provincial deficits have started to emerge, most notably in Ontario, where deficits of about $10 billion have been announced for the next three years. The net debt will also rise because of the budgetary measures of the federal government, which has curtailed transfer payments to provincial governments without corresponding reductions in mandatory spending or increases in taxation powers.

Second, the growth of the federal net debt as a percentage of GDP has been rapid only since the mid-1970s and has slowed somewhat since 1986. Budget projections by the federal government predict that the growth will become zero by the mid- to late 1990s. However, the recession of the early 1990s has raised serious doubts about the reliability of this forecast.

Third, as Figure 2 reveals, an important aspect of total public sector spending has shifted. Between 1970 and 1990, spending on goods, services, and capital formation remained unchanged at about 22 percent of GDP. Transfers to persons and business were 9.2, 13.0, and 14.9 percent of GDP in 1970, 1980, and 1990, respectively. But the largest increase in spending paid for interest on the public debt, absorbing 3.6, 5.4, and 9.4 percent of GDP during these three years. A substantial proportion of the growth in this particular category of spending is attributable to increases in interest rates that could not be influenced by the government of Canada.

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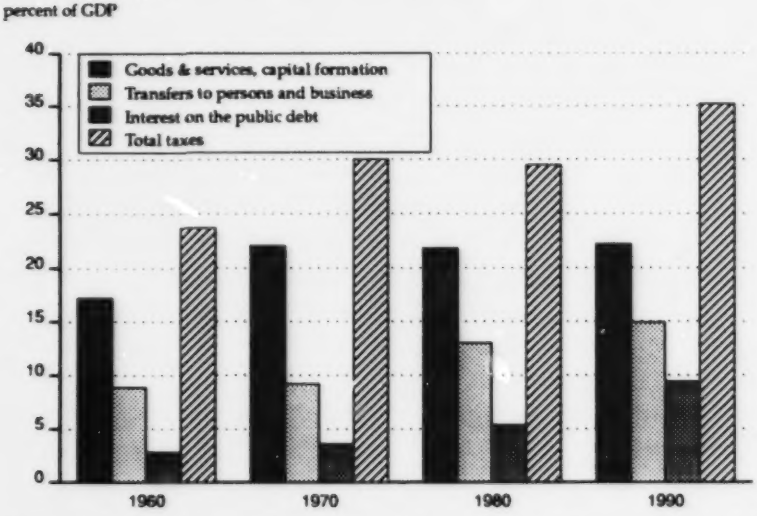
12 These figures hide the dramatic increase in spending on goods, services, and capital formation by provincial and local governments and hospital boards from 10.5 to 17.3 percent of GDP in 1960 and 1990, respectively, while federal government spending for the same purposes actually fell from 6.7 to 4.9 percent of GDP. See Figure 3 for these data.

Figure 2: ***The Evolution of Total Public Sector Expenditures and Taxes, 1960–90***



Note: Data are on a National Accounts basis. The total public sector includes the federal, provincial, and local governments, the hospital sector, and the Canada and Quebec Pension Plans.

Source: Canada, *Canadian Federalism and Economic Union: Partnership for Prosperity* (Ottawa: Supply and Services Canada, 1991), p. 32.

The Costs of High Debt

In my view, the data on the growth of the debt and the implicit level of deficit spending that underlies it are together indicative of a fundamental crisis of democracy in Canada. For nearly 15 years, deficit spending has been maintained during periods of economic boom — times when, traditionally, deficits are eliminated and surpluses are generated. I am skeptical that efforts to eliminate the deficit will be successful. Nothing has changed in the political process that produced 15 years of deficits to make me believe that the combined levels of government will actually achieve smaller overall deficits.

The large debt and expected continuation of deficits pose a problem for the Canadian economy for two basic reasons. First, the

financing needs of a debt-ridden government use up a substantial part of the nation's savings, and thus interest rates and the cost of capital go up. As a result, private capital gets crowded out of the picture, or, if more capital is borrowed abroad to fill in the gaps, obligations to foreigners are raised. Under either scenario, the real future income of Canadians drops.[13]

The second problem posed by a large debt is that the need to service the debt creates undesirable incentive effects. In fiscal year 1989/90, payments on the debt issued by the federal government represented 6 percent of GDP, 34.1 percent of budgetary revenues, and 37.4 percent of spending on transfer and exhaustive expenditure programs.[14] Further growth in these figures will inevitably result in an exhaustion of the taxation capacity of the nation; beyond a certain critical point, taxation can cripple a nation.

In countries where taxation approaches such a critical level, the incidence of tax evasion and avoidance rises drastically. These changes in the behavior of taxpayers shrink the tax base, and hence produce a need for even higher tax rates and further erosions of the base: a vicious cycle ensues. Ultimately, taxpayers are driven to force changes in a decrepit taxation system through the political process or by means of revolution.

Economic Effects of High Taxes

The most devastating economic effects of increased tax rates come about through the reduction in incentives to work, save, and invest. Emigration becomes an inviting option for capital and the most

13 Government debt obligations have a tendency to make citizens consume less and save more, knowing that they have to service the government debt in the future. This argument was made prominent by Ricardo and was revived recently by Robert Barro. In its extreme formulation, it implies that government deficits do not crowd out private investment. Evans reviews the empirical evidence and finds that it "can at most suggest that Ricardian equivalence is a good approximation" and that "Ricardian equivalence is not blatantly inconsistent with the data" (Paul Evans, "Is Ricardian Equivalence a Good Approximation?" *Economic Inquiry* 4 [October 1991]: 626–644).

14 Canada, Department of Finance, *Quarterly Economic Review, Special Report: Fiscal Indicators and Reference Tables* (March 1991), p. 30.

productive members of society, especially if, as in the case of Canada, a culturally similar country with lower taxes is well known and accessible. These developments invariably reduce the rate of economic growth, the ultimate determinant of both private living standards and the ability of government to finance spending on public goods and social welfare programs.

The widely held Keynesian view suggests that the size of the debt is immaterial to a country's well-being because funds to service the debt are taken away and returned to the citizens of the same country. The validity of this proposition disappears with high levels of deficits and debt, which cause public debt to be held abroad, because foreigners must ultimately be paid by the transfer of real goods and services, which, in turn, directly reduces the living standards of Canadian citizens. In the present context, the main shortcoming of this proposition stems from the neglect of the negative effects on incentive described above. Such an omission is inappropriate for an accurate analysis of a situation involving the high levels of debt developing in Canada.[15]

The Cost of Reducing Expenditures

As we approach the taxation saturation point of the Canadian economy, two economically and socially detrimental efforts will be made

15 Deficit spending is also unethical. It violates the rights of future generations, who are without voting rights or are not yet even born. Even if the debt remains at the present level, they face the prospect of having to pay 6 percent or more of their income in the form of taxes just to meet the interest due on deficits incurred by earlier generations. These debt payment obligations are in addition to tax burdens arising from the need to make payments to pensioners as well as those that they face to finance the government operation, health care, and education for their own generation.

Many Canadians consider it to be amoral to saddle future generations with such heavy debt burdens; they argue that, to a considerable degree, the debt they inherit will be matched by stocks of both real capital and knowledge capital. In fact, the burden of debt on future generations has not been discussed widely, and, in my view, it does not carry much weight in the justification of constitutional restraints on deficit spending. Nevertheless, reduction of this unethical burden on future generations may be seen as an additional benefit to be garnered by constitutional limits on deficit spending.

to reduce spending. First, essential types of government spending on infrastructure and the education and health-care systems will be restricted. These restrictions will produce even more negative effects on economic growth and social conditions.

Second, attempts will be made to lower interest payments on the debt and shrink the real size of the debt through money supply increases and inflation. This approach has been used successfully in the past. However, in today's world of integrated capital markets and highly sophisticated investment managers, the Bank of Canada cannot possibly follow this course of action. Inflationary increases in the money supply would result in lower interest rates for only a fleeting period of time. Actions of both lenders and borrowers in capital markets would quickly increase nominal interest rates to reflect the expected higher inflation rates. As a result, debt payments as a percent of GDP would remain virtually unchanged.[16]

An alternative approach to lowering the interest rate involves the use of direct controls. These would have to be complemented by strict foreign-exchange controls in order to avoid international capital flight. Such controls do work but only with highly undesirable consequences for freedom, income distribution, and efficiency of capital markets. In particular, Canadian pension funds and their owners would suffer reductions in wealth and pension incomes.

In sum, the continued growth of government debt will inevitably lead to higher taxes. These in turn will reduce economic growth and erode the supply of government services; emigration of both people and capital will be encouraged; history and foreign experiences would predict a risk of increased inflation and the dangerous

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16 Nevertheless, the temptation to inflate away the debt problem will always be with us. For a scholarly analysis of the dilemma posed by persistent deficits and the incentives it creates for politicians, see Thomas Sargent and Neil Wallace, "Some Unpleasant Monetarist Arithmetic," *Federal Reserve Bank of Minneapolis Quarterly Review* 5 (1981): 1–17. The widely held view that inflation is a lesser evil than unemployment and slow growth fuels the temptation to use inflation for the elimination of the debt burden. During 1990 and 1991, the Bank of Canada's high interest rate policy, which was aimed at limiting inflation, was criticized by many prominent economists and politicians holding this view.

use of direct controls. All of these developments involve undesirable reductions in the living standards of Canadians and the violation of fundamental economic and social rights.

High Spending Levels

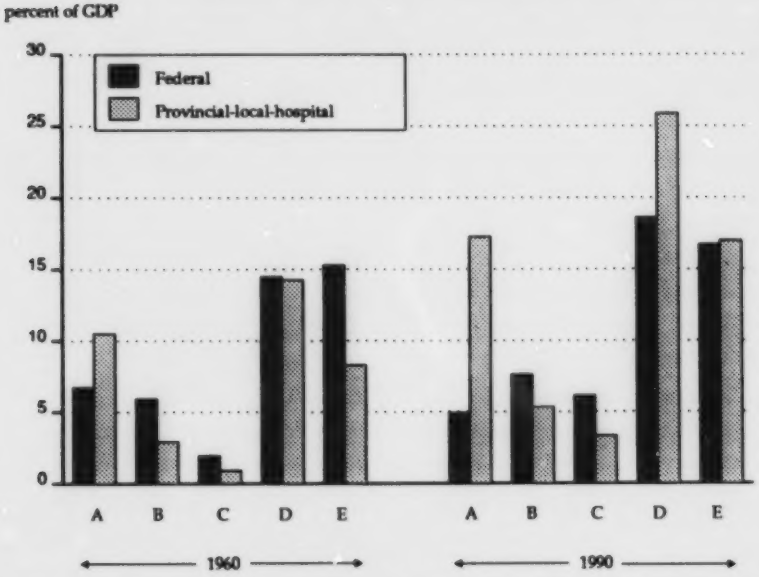
The level of government spending in Canada increased sharply between 1960 and 1990, as can be seen in Figure 3. Federal spending rose from 14.5 to 18.6 percent of GDP in 1960 and 1990, respectively, which represents a 28.3 percent increase in the share of GDP. However, this general picture of the overall growth in spending levels hides some important and disturbing facts. Federal spending on real goods and services, which tends to raise productivity, dropped 27 percent as a share of GDP. During the same period, transfer payments, which have significant negative effects on effort and productivity, increased 29 percent as a share of GDP.

Furthermore, the facts about federal spending levels tell only part of the story. Provincial and municipal governments and hospital boards also raised outlays. Spending on real goods and services and on transfer payments, rose 65 percent and 186 percent, respectively, as a share of GDP.[17]

In 1991, the federal government introduced legislation to limit spending on items other than debt service to 3 percent per year in nominal terms, which is likely to force a reduction in total spending as a percent of GDP. This spending restraint is welcome. However, it remains to be seen whether or not the government has the determination to follow through on its intentions, and if future governments, possibly consisting of different political parties, will retain it. As in the case of the approach to deficits, I have seen no changes in the political system, which created the growth and high levels of

17 These spending figures must be interpreted with care. Much of the increase in real spending represents medical care and education expenditures required by federal programs and financed through revenue sharing. Much of the transfer spending was also made mandatory by federal government programs and financed by corresponding payments to the provinces.

Figure 3: ***Comparison of Federal and Provincial-Local-Hospital Sector Expenditures and Taxes, 1960 and 1990***



Key: A = Goods & services and capital formation; B = Transfers to persons and businesses; C = Interest on the public debt; D = Total expenditures; E = Total taxes.

Note: Data are on a National Accounts basis.

Source: Canada, *Canadian Federalism and Economic Union: Partnership for Prosperity* (Ottawa: Supply and Services Canada, 1991), p. 32.

recent decades in the first place, that would make me optimistic that spending levels will decrease substantially in the near future.

Public Choice Interpretation of Spending

According to the traditional view about the nature of government, the high spending levels just discussed must reflect the will of the people. Similarly, all programs must raise the efficiency of the economic system and produce a publicly preferred distribution of in-

come. In recent decades, however, a modern theory about the nature of governments, commonly known as the theory of public choice, has questioned the validity of the traditional view. This theory has been able to explain the existence of a wide range of government programs and policies, which, in the view of most dispassionate observers, are detrimental to the public interest. These include marketing boards, rent controls, minimum wages, and tariffs, as well as excessively high unemployment insurance benefits[18] and subsidies to a wide range of industries.

According to the modern view, these programs and policies come about because unethical politicians attempt to secure the voter loyalty of special-interest groups by granting them legislated benefits, the costs of which are too small, when taken individually, to generate any sort of organized opposition from the general public that must ultimately pay for them. Modern technology, by effectively lowering the costs of massive organization, has resulted in an historically unprecedented growth in such interest-group legislation.

Niskanen provides an additional explanation of the rapid growth of government spending.[19] He argues that bureaucrats have strong incentives to increase the size, number, and scope of the spending programs they oversee, since their personal income and status increases proportionately with the size of the expenditures they administer. Bureaucrats can achieve these self-interested goals by providing biased interpretation of information and by facilitating a symbiotic relationship between politicians and special-interest

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18 For further theoretical and empirical evidence on this analysis, see Herbert Grubel, Dennis Maki, and Shelley Sax, "Real and Insurance-Induced Unemployment in Canada," *Canadian Journal of Economics* 18 (May 1975). This paper provides a study of the reasons for the growth in the cost of unemployment insurance payments in Canada. The findings were confirmed by the Economic Council of Canada and received a further official stamp of recognition in the Forget Commission Report on the Canadian Unemployment Insurance System. In Herbert Grubel, "The Costs of Canada's Social Insurance Programs," in George Lermer, ed., *Probing Leviathan* (Vancouver: Fraser Institute, 1984), I applied the analytical tools used in the explanation of the growth in demand for unemployment insurance to explain the growth in other social insurance spending.

19 Niskanen, *Bureaucracy and Representative Government*.

groups. The ability of bureaucrats to achieve these objectives has also increased as the cost of communications and information has come down.

The increased spending attributable to the activities of special-interest groups and bureaucrats has produced a large and growing waste of economic resources; consequently living standards and growth rates have dropped. These reductions represent a violation of the fundamental economic right of all Canadians to enjoy the fruits of their labor, investment, and risk-taking. The proposed constitutional restraints on spending levels, as outlined in this essay, can ensure that Canadians will once again enjoy this economic right.

High Spending and Economic Growth: Some Evidence

Strong evidence exists to support the case that government spending reduces the economic growth rates of individual countries. Lindbeck, in a number of studies, documents the decline of Sweden's economic fortunes, which resulted from an increase in costly social programs in recent decades.[20] High government spending and taxation accompanied Britain's economic decline between the end of World War II and the election of Margaret Thatcher in the 1970s. Only the fiscal restraint of Thatcher's regime reversed this trend. Somewhat less known is that Germany's outstanding record of economic growth during the postwar years was accompanied throughout by low levels of both spending and taxation. Since the 1970s, Germany's spending and taxation programs have been among the highest while

20 During the mid-1960s, before the initiation of its famous welfare and tax programs, Sweden had been among the top three countries in the world in terms of per capita income and real growth rates. Twenty years after the start of these programs, Sweden moved into the middle rank of countries in the Organisation for Economic Co-operation and Development (OECD) according to per capita income. This position was reached as a result of a reduction in the rate of growth, which put it last among the OECD countries. See Assar Lindbeck, "Swedish Industry: In a National and an International Perspective," *Scandinaviska Enskilda Banken Quarterly Review* 3 (1988): 60–71; and idem, "The Swedish Experience" (Institute for International Economic Studies, Stockholm University, Seminar Paper, no. 482, December 1990).

its economic growth rates have been near the lowest of the OECD countries.[21]

The preceding evidence on the correlation between government spending and economic growth is backed by scientific studies involving large numbers of countries undertaken by Marsden,[22] Reynolds,[23] and Rabushka.[24] Additional evidence stems from a study of U.S. states, 49 of which had balanced budget requirements in 1984 and a smaller number of which had limitations on spending levels. This study concluded that "the higher the level of state and local taxes, the lower the rate of economic growth."[25] Olson analyzed the different rates of economic development of Germany and the United Kingdom during the postwar years.[26] To a large extent, he attributes Germany's comparatively better economic performance to the destruction of all German special-interest-group legislation following the loss of the war.

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21 Argentina, New Zealand, and Australia were among the countries with the highest per capita incomes until they vastly expanded the role of government in the economy and, in particular, raised spending and taxation programs and incurred large spending deficits. Since then, economic growth rates in these countries have stagnated and their per capita income levels have dropped behind that of many other countries.

The point about the detrimental effect of high spending and taxation on growth is reinforced by the experience of a number of countries that have succeeded in attaining high growth rates while maintaining policies of low spending and limited deficits. Examples of countries with these characteristics are Singapore, Hong Kong, Taiwan, and South Korea, the so-called little tigers of Southeast Asia.

22 Keith Marsden, "Links Between Taxes and Economic Growth: Some Empirical Evidence," World Bank Staff Working Papers 604 (Washington, D.C.: World Bank, 1983).

23 Alan Reynolds, "Some International Comparisons of Supply-Side Policy," *Cato Journal* (Fall 1985).

24 Alvin Rabushka, "Taxation, Economic Growth and Liberty," *Cato Journal* (Spring/Summer 1987).

25 Richard Vedder, "Do Tax Increases Harm Economic Growth and Development?" in *Taxpayers Resource Book*, vol. 2 (Washington: National Taxpayers Union Foundation, 1989), p. 87. For a detailed review of this study, see ibid.; and Advisory Commission on Intergovernmental Relations, *Fiscal Discipline in the Federal System*.

26 Mancur Olson, *The Rise and Decline of Nations: Economic Growth, Stagflation and Social Rigidities* (New Haven: Yale University Press, 1982).

Gambling with Canada's Future

The high government spending deficits and levels of recent years have been caused, to a considerable degree, by the efforts of special-interest groups to cater to politicians' and bureaucrats' selfish motives. The effectiveness of these groups in recent decades developed as a result of the lower costs of communication and transportation caused by technological innovations. Much of the resulting spending does nothing to increase the welfare of the average Canadian. On the contrary, it is a wasteful practice that lowers the living standards of current and future generations of Canadians. In addition, high levels of spending of this nature produce no gains in the quality of life or, indeed, in any other social, nonmeasurable aspects of life.

The lowered income of Canadians generated by this wasteful spending reduces the fundamental economic right of Canadians to the fruit of their labor and investment. In the long run, however, more than a violation of economic rights is involved. The practical difficulties of dealing with the deficit increase the temptation of governments to resort to inflation or direct controls to assure economic stability. These temptations constitute a growing threat to the very existence of the system of freedom and democracy.

How great is this threat to the system? On the one hand, Canada has had a long history of stable, democratic government. One would hope that chances are good that social and political instabilities can be avoided. On the other hand, the history of the world is full of instances in which these very conditions have brought on political chaos and the loss of democratic and personal freedoms. Hitler's rise to power in Germany was, to a considerable degree, due to the economic and social dislocations brought about by the hyperinflation of the 1920s. Excessive spending and deficits during the interwar period in China, Hungary, and Austria caused serious economic, social, and political problems. In recent times, the economic and social instabilities in Latin America, as well as the rise of military

dictatorships in that area of the world, are all related to irresponsible government deficit spending and the resultant inflations.[27]

Canada's future is highly uncertain. The federal government may or may not be able to control the growth of spending and deficits with sufficient speed to avoid the dangers that come with ever higher levels of debt and interest payments. There may exist methods unknown to me — and therefore not reviewed in this paper — by which Canadian governments can avoid the costly consequences of high and growing levels of debt payments. And even if spending and deficits do continue to grow and the predicted slowdown of economic growth and cut in social services take place, thus lowering the standard of living, it might not be a complete disaster — the people of Canada may still have the fortitude to maintain their tradition of democracy.

In my view, however, it is abundantly clear that the continuation of past trends raises the probability that some or all of the undesirable developments will take place. The proposed constitutional limits on government spending deficits and levels are a promising way out of a difficult situation; they constitute an insurance policy against the occurrence of such calamities in Canada. They will protect not only the present generation but also future generations against the consequences of yet unforeseen conditions that might favor the growth of government spending and use of deficits in the future.

The Need for Constitutional Fiscal Restraints

The merit of constitutional restraints on government spending deficits and levels depends to a considerable degree on whether or not

27 The experience of Argentina is particularly telling in this respect. Its government turned one of the most prosperous and stable countries of the world into one of the lowest performers of all the middle-income countries. Democratic institutions and liberty were violated repeatedly by military juntas that attempted to restore a semblance of economic stability and prosperity, all justified on the grounds that democratically elected legislatures were unable to solve the economic problems.

the trends in spending and deficits discussed above are considered permanent. I first discuss this issue by reviewing the role of Keynesian and socialist economic doctrine, which spread during the postwar years. The second part of this section deals with the impact technical change has had on the effectiveness of special-interest groups and the consequent inability of the political system to control spending and deficits.

The War of Ideas in Economics

Buchanan and Wagner argued that, before the 1970s, deficits and excessive spending by Western governments were constrained by public opinion, which they considered to be equivalent to an unwritten constitutional restraint on the political system.[28] The basis of this public opinion was a strongly held common belief that for private persons to incur debts was both immoral and detrimental, and that this same moral stricture applied to governments.

This traditional, unwritten constitution against deficits began to break down rapidly during the postwar years as a result of an almost universal acceptance of the validity of Keynesian economic theory. According to this theory, deficits do no harm to the economy and society: interest payments on public debt are nothing but transfer payments that require taking money away from some people and giving it to others.

Moreover, according to this theory, deficits actually have beneficial effects. When they are incurred during recessions and are matched by surpluses during booms, they reduce the length and severity of unemployment over the full business cycle. More important in breaking down the public strictures of deficits was the spread of the Keynesian idea that permanent deficits can be used to increase aggregate demand and reduce unemployment permanently through the exploitation of the well-known Phillips curve tradeoff between employment and inflation.

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28 James Buchanan and Richard Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, 1978).

The ultimate victory of these Keynesian ideas about the multiple benefits to be derived from deficits was achieved during the 1960s and 1970s, when economists trained in these doctrines reached positions of power as advisers in governments in Canada and the United States. Because of the newfound, widespread public acceptance of the ideas, politicians could act on the advice of these economists and vote for large and lasting deficits — all without facing the risk of retribution by the electorate.

The development and widespread acceptance of the ideology of socialism and communism during the postwar years also had considerable influence on the increased acceptability of high spending levels in Canada and other Western countries. The Great Depression, combined with the apparent economic and social successes of communist countries in Eastern Europe, provided the fuel for profound reassessments of the merit of free markets. Sophisticated models were developed to show that government spending could deal with the serious pathologies of capitalism and could create a more equitable society with high and stable growth, all at the cost of a small loss in personal freedoms.[29] The widespread acceptance of these ideas increased the election chances of politicians who promised increased government spending for income security and equality, thus expanding the problem of uncontrolled spending.

Buchanan and Wagner cite the breakdown in traditional public values in their proposal for the introduction of spending restraints in the U.S. Constitution. However, I am not convinced that much emphasis should be given to these developments as justification for constitutional restraints in the Canadian Constitution. On the one hand, since the 1970s many of the central propositions of Keynesian economics have become discredited. More recently, the abandon-

29 In the wake of *perestroika* and the resultant revelation of the failure of communism, new research has revealed many references to the views expressed by former leading economists and intellectuals. For example, Paul Samuelson's influential introductory economics textbook asserted, in many editions, that communist economic policies had the merit of producing greater income equality and economic growth and stability than the free market could provide and that their only demerit was the loss of freedom of individuals.

ment of the communist system in Eastern Europe has discredited the ideology on which it was based. Therefore, politicians may soon be facing the traditional public disapproval of spending deficits and the wrath of voters revolting against high spending levels. If too much emphasis had been placed on the missing public stricture as justification for restraints, pundits would be telling us that the need for restraints was gone.

On the other hand, deficits and the growth in spending are still out of hand in Canada. Ideologues of the left are rationalizing the failure of Keynesianism and the East European regimes, and want to see these failures as the result of tactical errors that could be avoided in the future. The history of intellectual movements suggests that the lessons of the past eventually will be forgotten and traditional arguments in favor of deficits and high government spending will once again become respectable, most likely in some new formulation. Therefore, there is merit in constitutional restraints, public disapproval of spending deficits or not, if only to make it more difficult to revive such policies some time in the future.

Special-Interest Groups and Bureaucracies

The most persuasive argument in support of constitutional spending limits is the increasing power of special-interest groups and bureaucrats, as discussed above. Special-interest groups, bureaucrats, and politicians have existed ever since the first government was formed, yet they never exerted undue influence until recently. Why did they not raise spending and taxes and create detrimental economic effects long ago? Is their recent rise to power likely to peak or be reversed at some time in the future? Are there no countervailing forces to reduce their power? The answers to these questions are important. If a natural process could be counted on to reverse recent trends, the argument in favor of limiting the power of these groups through constitutional clauses would be weakened considerably.

First, the power of these groups has risen as a result of a considerable drop in the costs of communication and travel. These

technological developments have lowered the real cost of organizing special-interest groups and of their lobbying efforts with politicians. Second, most modern elections are won by such slim margins that no politician can afford to lose the support of any interest group, however small and however outrageously self-serving its demands might be. Mix these two factors together and you get the makings for financial disaster.

The electronic media, in particular, have increased the effective power of interest groups, which have become masters at manipulating radio and television to serve their own purposes. With the help of the media, an interest group can readily generate an avalanche of mail to lawmakers and thus influence legislation. During the past few years, several spending and taxation programs of the Mulroney government aroused the fury of special-interest groups, which attacked the government with the support of the media. As a result, several programs were scuttled or altered drastically, and the Progressive Conservative party's support in opinion polls suffered severe setbacks.[30]

It is important to note that the public choice and bureaucracy model of government spending and deficits does not cite any changes in the morality of politicians or bureaucrats as responsible for the observed developments. Politicians and bureaucrats in office during recent times are likely to have the same, if not higher, moral standards as their predecessors. The technological advances responsible for the increased power of special-interest groups are not

30 Examples of these programs were taxation of government benefits paid to pensioners with high incomes, the reduction of passenger services provided by VIA Rail, and lower contributions to women's groups designated to finance lobbying with the government. All of these government initiatives had widespread support among economists and other analysts of the efficiency and costs of government programs.

One of the ironies of modern interest group politics is that, in the 1970s, the Trudeau government organized some special spending programs to provide financing for the formation of such groups. According to Peter Brimelow (*The Patriot Game* [Toronto: Key Porter Books, 1988]), the Liberal party adopted this strategy in the hopes that it would be possible to remain in power by ensuring the voting and financial loyalties of new interest groups through appropriate legislation.

reversible or likely to be offset by other technical changes.[31] For this reason, constitutional limits on spending and deficits represent the most promising approach to dealing with the consequences that these technological advances have had on the political system, economic rights, and the prospects for a democratic system in Canada.[32]

Creating Restraint Provisions

In this section, I present some ideas to show how constitutional spending restraints could be made operational. Practical application will not be an easy task, for the following reasons. First, there exists a bewildering variety of theoretical models of how to bind legislators

31 The Canada-U.S. Free Trade Agreement has curtailed the power of some special-interest groups by increased competition. For example, the benefits of agricultural supply management and of the union membership of supermarket employees have been curtailed and may be eliminated by crossborder shopping. Free trade has brought into the open the otherwise hidden cost of the benefits accruing to these interest groups at the expense of the public. In my view, this development, though rarely discussed, is one of the most important benefits of the Free Trade Agreement.

32 An important idea in the study of economics maintains that competition exists in all markets, including the market for political favors to special interest groups. In such markets the potential gains from participants are limited by the budget constraint, which limits the total benefits that all of the special interest groups can obtain together. In the end, efforts by any one group to increase its benefits come only at the expense of other interest groups, which in turn devote most of their efforts to defend gains already won. This competition model has been used by Gary Becker ("A Theory of Competition among Pressure Groups for Political Influence," *Quarterly Journal of Economics* 97 [August 1983], p. 37) to argue that there is little reason for concern about the power of interest groups and the damage they can do collectively to the economy.

The validity of this conclusion depends on the existence of a budget constraint provided by public censure of deficits and high spending levels. The history of economic ideas and the actual deficits and spending in Canada suggest that this unwritten budget constraint has been weak in recent decades. The proposed constitutional limits are designed to assure the existence of a budget constraint and to force the outcome predicted by Becker's model.

to limits. The federal government will have to choose one course of approach and stick to it.

Second, all possible approaches involve tradeoffs in means, ends, and risks; they cannot be avoided. Legislators should therefore expect that implementation of the spending limitations will require time-consuming negotiations involving many ideological, legal, and technical problems.

Third, by becoming entangled both intellectually and emotionally in designing the details of restraint procedures, one could easily become despondent about the likelihood of finding acceptable and workable solutions. We should therefore try to remember that existing U.S. restraint systems work effectively and that acceptable solutions to the problems do exist.

Fourth, simplicity and transparency in the operation of restraint procedures are more important than economic purity or technical elegance. Constitutional restraints must serve as well as be seen to be serving the interest of all Canadians. Reasons for the choice of particular procedures must be explainable in simple terms. If possible, detailed rules for implementation should be in legal statutes rather than the constitution itself, where only main principles and basic guidelines should be presented.[33]

To simplify the discussion, I have limited my consideration to one model that appeals to me and that can serve as a basis for extensions and modifications. I provide references for literature that reviews alternatives.

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33 The operation of this principle may be seen most readily in the case of the constitutional guarantee of freedom of speech. Many times in U.S. history, legislatures passed laws to prohibit people from yelling "fire" in crowded theaters and, what was somewhat more controversial, prohibit the sale of pornographic material. The judiciary has been required to decide whether or not these and other laws violate the constitutional mandate of freedom of speech. A constitutional clause could not have foreseen the difficulties and would have been too unwieldy if it had attempted to specify all possible cases of laws to which the freedom of speech abuse might apply. Similarly, flexibility and strength of basic purpose should be embodied in the wording of constitutional spending restraints.

One Restraint Proposal

An Outline

Spending Limits

> *Spending by the government of Canada must not exceed a specified percentage of national income, which implies that it cannot grow at a rate faster than the growth in national income.*

In operational terms, this means that rates of planned annual spending increases, in real terms, must not exceed the average annual growth rates of real income during the preceding five years plus a rate equal to the expected rate of inflation during the year.

Prohibition of Deficits

> *The government of Canada must not incur spending deficits over the full business cycle.*

In operational terms, this means that planned annual tax revenue increases each year must equal the average annual growth rate of tax revenue during the preceding five years. Because spending grows at the same rate, the budgets of one complete business cycle will be balanced on average.

In any budget year, actual spending and actual revenues can differ as a result of cyclical fluctuations. When actual revenues exceed actual outlays, the surplus goes into a rainy day fund. When actual spending exceeds actual revenues, the shortfall can be withdrawn from the rainy day fund.

When the rainy day fund exceeds 10 percent of annual spending, the surplus funds must be returned to taxpayers through appropriate reductions in the following year's tax liabilities. If the rainy day fund balances are drawn down and threaten to become com-

pletely depleted, the next budget must raise tax rates or broaden the tax base to eliminate any projected deficits.

Suspension of Requirements

The limits on spending and deficits can be suspended for a maximum of two years by a resolution in Parliament passed with a two-thirds majority.

Penalties

If total spending exceeds the specified percentage of national income or the rainy day fund is exhausted, an election must be held two months later.[34]

Choice of Spending Levels and Rates of Increase

The concept of an optimum spending level involves some fundamental assumptions about the role of government in society. A thorough discussion of the range of ideological views is not possible here and, furthermore, is unlikely to yield useful results. Pragmatically, the spending levels in existence could form the basis for a debate about desirable levels for both the short and long run. I can envisage the adoption of a spending limit as a percentage of GDP, equal to that of the last five years. Provisions can be made to reduce it by some percentage, say 25, during the following ten years.

The selection of this long-term target is crucial, and a lengthy public debate should precede its enshrinement in the Constitution.

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34 In reactions to the proposed penalty, several Canadians have suggested to me the desirability of other forms of penalty. One example would make members of the party or of the cabinet in power ineligible for re-election during the mandated election. Another popular suggestion would reduce the pension rights of such members of Parliament.

At the same time, it should be remembered that the selection could be altered, as the Constitution will almost certainly contain a formula for amendment.

Once a desired level of government spending, as a percent of national income, has been achieved, annual spending can increase only at the rate at which national income increases. However, the existence of business cycles, and divergences in the prices and productivity of the private and public sector are likely to make the implementation of this simple rule economically inefficient.[35] In my view, the solutions for these time-specific problems should be included in statutes rather than the Constitution.

Expenditures for Inclusion

To be helpful to politicians, the establishment of a spending limit should be accompanied by a detailed list of spending categories. This section describes the major categories for inclusion or exclusion from limitations.

Program Expenditures

The class of expenditures — known technically as program expenditures — clearly must be included in the set to be limited. This category consists of all spending on public goods, such as education, health, defense, the judiciary, regional development, foreign aid,

35 The technical problems that cause this inefficiency are as follows. First, during a recession, when a deficit is incurred and permitted under the rainy day fund provision, spending rises more rapidly than tax revenue. Second, inflation that affects public sector output more than private sector output will produce the result that an equal percentage increase in GDP and spending reduces the real share of government in the economy. Third, an analogous result is brought about by the slower productivity growth in the public relative to the private sector. The last two problems would become important only in the long run but cumulatively could still have a significant impact on the efficiency of the mixed economy unless they are corrected by devices, the design of which should not be beyond the skill of accomplished economists and lawyers.

international representation, and social overhead for facilities such as airports and harbors. The second category for inclusion is comprised of transfers to persons under social assistance, unemployment, support for the native population, and so on. In addition, program expenditures include transfer payments to poor provinces.

Debt Service

Debt-service payments should be excluded from the limits on spending levels because their size has been predetermined by previous governments and is heavily influenced by interest rate levels over which the government has very limited control. Moreover, if debt service were included and the debt ceased to grow because of the prohibition on deficits, the payments, as a percentage of GDP, would fall with economic growth through time, which, in turn, would leave room for undesirable spending.

However, debt payments should be included in annual budgets subject to the prohibition on deficits. Otherwise, the debt payments could be financed by borrowing and, in the extreme, irresponsible governments could increase the size of the debt and interest payment obligation at the rate of interest.

Tax Expenditures

Governments usually provide benefits to special-interest groups through traditional programs of spending or subsidies. However, they can also provide benefits of equal value by granting tax concessions. The use of these so-called tax expenditures is popular with both politicians and beneficiaries because the costs do not appear in annual budgets and therefore escape the usual competition for resources within the government. To curb this half-hidden leak of government funds, tax expenditures should be limited to curtail the undesirable expansion of government influence, especially when outright spending is limited by constitutional clauses.

During the 1970s, the idea of controlling tax expenditures received much political and academic attention. However, no policies came of this work, primarily because of difficult conceptual problems encountered in defining tax expenditures. The most revealing of these appears when one asks whether basic personal exemptions in income tax are tax concessions. After all, they give a break to taxpayers at the expense of a reduction in the tax base. This example would seem to imply that the government has a right to tax rates taking away 100 percent of income, so that everything short of that represents a tax expenditure.[36]

These conceptual and practical difficulties suggest that tax expenditures would best be omitted from the design of general spending limits. In the long run, the public would be protected from the excessive use of tax expenditures by political forces: raised tax expenditures reduce the tax base and thereby force costly increases in tax rates if the government in power is to maintain total revenue. This unpopular measure would certainly exact its price at the ballot box.

Unfunded Liabilities

Politicians also court special-interest groups by providing their members with legislated social security benefits, the real costs of which only appear in future budgets. Outstanding examples of such practices are promises of generous pension benefits to government employees and higher pension or health benefits under the Canada Pension Plan. Only a very small fraction of the cost increases caused by such legislation appears in the budgets of the government passing

36 David Keating has pointed out to me that the indexation of Canadian income tax can be interpreted technically as a tax expenditure because it has resulted in the lowering of tax payments by Canadians. The elimination of indexation would imply a reduction in such tax expenditures. Therefore, a government operating under a grandfather clause, which would be necessary after the introduction of spending limits and the inclusion of tax expenditures in the limit, could increase income tax rates and spending without violation of the limits on total spending as a percent of GDP. The result of such a set of policies would clearly be in violation of the spirit of the proposed constitutional spending limits.

it because the bulk of payments is scheduled to take place in the future.[37]

Achievement of the intent of constitutional restrictions on spending levels requires, therefore, that any legislated changes to the present value of such unfunded, contingent liabilities be accounted for in budgets and credited to the total spending limit. This proposal forces governments to make policies that are economically efficient as well as equitable for future generations.

Seigniorage

Modern governments have a substantial and regular income as a result of their "seigniorage," or revenue arising from the issue of bills and coins and from the central bank's holding of interest-earning government securities that are matched by deposits from commercial banks, which pay no interest.[38] In practice, seigniorage enters into the general revenue of the federal government when central bank profits are transferred. These revenues should be counted explicitly in the determination of deficits and limits on total spending.

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37 The value of the unfunded liabilities of the pension plan for the Public Service of Canada was $4.2 billion on December 31, 1986, though by the end of 1989 actuaries had assessed it to have been only $2.4 billion (see Canada, Office of Superintendent Financial Institutions, *Pension Plan for the Public Service of Canada, Actuarial Report* [Ottawa: Supply and Services Canada, 1991], p. 22). Before the 1990 report on the Old Age Security Program, an analogous figure for the unfunded liabilities had been published upon request of the Auditor General of Canada. However, the 1990 report merely expresses the annual payment obligations until 2100 as a percent of total earnings. Depending on assumptions about population, earnings, and inflation growth rates, the rate for 2035 varies from 6.77 percent to 3.12 percent with the "best" projection of 4.61 percent of earnings. See Canada, Office of the Superintendent of Financial Institutions, *Old Age Security Program: First Statutory Actuarial Report* (Ottawa: Supplies and Services Canada, 1990), various tables.

38 In West Germany during the 1980s, the treatment of seigniorage in the form of profits by the Bundesbank became a hot political issue when the government contemplated changing traditions. It wanted to count seigniorage like tax revenue and thus offset current expenditures. The sums involved were substantial and represented about 3 percent of total federal government outlays.

Decentralized Government Structure

As a result of the Quebec independence movement, Canada is likely to adopt a new form of confederation in which some of the traditional spending programs will become the responsibility of provincial governments. These programs cover higher education, regional development projects, health, welfare of natives, fisheries, and others. Reductions in, and possibly the elimination of, federal transfers to the provinces for these types of programs will reduce total federal and increase total provincial spending budgets. The proposed constitutional limits for the different levels of government should, of course, reflect these changes.

Protection of Provinces

One of the ways in which politicians at the federal level of government can and have courted the favors of special-interest groups has been to make provincial programs meet costly mandatory standards that can be met only by taxes raised by the provincial governments. The outstanding example of such an exercise involves health care. The federal government has prevented provinces from restricting access to the health system through such measures as user fees, while failing to maintain transfer payments at levels adequate to meet the demand generated by a universal system. Such abuse of federal government power and potential violation of spending restraint provisions must be prohibited by appropriate statutes.

Investment

Efficiency in the allocation of resources between time periods and different generations of people requires that all capital formation be financed by borrowing. The effect of such borrowing is to raise the interest rate and to signal to market participants the relative costs of present and future consumption. Similarly, government spending that leads to such real capital formation, after the depreciation of

existing stocks, should also be financed by borrowing. The resultant growth in the public debt would have none of the negative effects discussed above. Future generations would face higher tax payments to service the debt, but they would also enjoy a corresponding stock of maintained roads, sewers, schools, hospitals, and other real capital owned and operated by their governments.

One of the most important insights of postwar economics has been the discovery of the quantitative and qualitative significance of social capital in the form of education, health, and knowledge. In principle, such capital formation should also be financed by borrowing so that the efficient intertemporal allocation of resources will be assured. However, I recommend that such spending on human and knowledge capital be financed from current revenue, preferably by means of a statute. In practice, it is very difficult to measure depreciation and therefore net capital formation resulting from these types of expenditures. This handicap would permit opportunities for political manipulation of the estimates of allowable exclusions from current spending limits. The efficiency costs of financing from current revenue are likely to be relatively minor relative to the potential costs of the political manipulations possible under the economically more appropriate approach.

The Rainy Day Fund

The proposition of a rainy day fund causes one to ask why it is preferable over a simple prohibition of all deficits. On the surface, the rainy day fund seems to complicate the process and open opportunities for political manipulation. There are, in fact, two main reasons for maintaining a rainy day fund.

The Difficulty of Maintaining a Continuously Balanced Budget

Budgets, by their very nature, can only be forecasts of the actual spending and revenues covering a certain length of time, typically a

year. Actual spending and tax revenues are almost always different from those planned because of a host of random influences beyond the control of the government, such as the forces of nature, foreign economic forces, and business cycles.

These forecasting uncertainties ensure that maintaining a consistently balanced budget, although not impossible, would create undesirable inefficiencies. For instance, a temporary decrease in foreign demand for Canadian goods might reduce economic activity and tax revenues in a given period. The maintenance of the budget balance would require an immediate and corresponding decrease in spending on education, health, road maintenance, or similar programs, in order to make up for the assumed shortfall in tax revenues. Such spending cutbacks of essential programs are not efficient.

Another problem with attempting to balance every single budget is that budgets require the assumption of a finite time period over which the balance has to be achieved. But, in practice, tax revenues and expenditures cannot be equal every hour, day, or even week. Essentially, the proposal for the establishment of a rainy day fund selects the business cycle as the period over which a balanced budget must be achieved. The length of this period will have to be set in a statute after careful consideration of historic experience and economic theory. The period should be long enough to permit surpluses and deficits — caused by nature and other external circumstances — to offset each other and create a balance, much as they did during the long periods of time in Canadian history during which there was no net growth in the size of the debt.

Business Cycle Stabilization

The second reason why a rainy day fund is desirable is found in modern macroeconomic theory. In particular, the flexibility of a rainy day fund permits built-in stabilizers to reduce the size of business cycle fluctuations. For instance, cyclical decreases and increases in demand by consumers and investors can be offset, to some degree, by the complementary increase and decrease in government spend-

ing due to cyclically variable outlays under unemployment and other social insurance programs. Similarly, cyclical variations in tax payments will affect the after-tax income of consumers and investors and result in more stable aggregate demand.

In practice, it is difficult to assess whether surpluses and deficits are cyclical or the function of fundamental structural changes that generate a permanent change in spending levels and taxation revenues. For this reason, an initially balanced spending and taxation program could easily lead to unexpected growth or depletion of the rainy day fund during a business cycle, and governments should have the opportunity to correct minor fluctuations in their subsequent budgets.

Achieving Balance with the Rainy Day Fund

I propose that, when the depletion of the rainy day fund approaches a zero balance, the government be required to take corrective action by lowering spending, raising taxes, or both. Total depletion of the fund would trigger the dissolution of Parliament. On the other hand, excessively high funds, at something like 10 percent of total spending, should trigger adjustments to taxation and spending programs to eliminate the excess. Increased spending, of course, has to be considered in the light of the limitation on the permitted level.

It would only be a lucky coincidence if the rainy day system for cyclically balanced budgets came into operation at the beginning of a boom, thus permitting the accumulation of funds. At any other time, setting aside the funds would require immediate and economically undesirable changes in taxation and spending.

For this reason, the rainy day fund would probably have to be endowed initially with a certain sum of money. Unfortunately, this would have to be raised by the sale of government securities and an increase in the government debt. However, because the rainy day fund can use its endowment to buy government securities, the net debt in the hands of the public would remain unchanged by such a course of action.

Problems in the Design of Restraint Provisions

Penalties

One fundamental objection to the use of constitutional limitations on spending and deficits consists of the lack of obvious mechanisms for punishing violators. Proponents of this argument claim that constitutions can make many demands that may not be met. For instance many totalitarian countries assure civil liberties and *habeas corpus* in their constitutions, yet the citizens of these countries enjoy none. Such regimes would certainly disregard a provision demanding that they call an election upon exhaustion of a rainy day fund — just as they violate the civil rights of their citizens.

But Canada is anything but a totalitarian country. Canada has a long history of democratic and responsible government acting with due process and within a universally respected legal framework. Constitutional spending limits, quite simply, would be obeyed. The judicial system could be used to establish when violations take place using the technical specifications that are outlined below. Penalties would be enforced.

Objections can also be raised concerning the severity of the proposed punishment. It may seem harsh to force an election call regardless of the particulars, especially if one considers that some violations may be due to circumstances beyond the control of the government or ruling coalition.

This argument falls flat, however, because the severity of the punishment would be taken into account when the permitted spending limits and the size of the rainy day fund are first established, such that a substantial margin of safety will exist. Studies of historic, cyclical swings in the growth rates of national income, mandatory spending, and tax revenues can provide reliable information for estimating appropriate spending limits and the size of a rainy day fund. After the initiation of the system, the threat of penalty assures that politicians will curb the growth in spending and taxation and

maintain the rainy day fund as a margin of safety. Politicians who gamble with the safety margin in order to gain short-run benefits for themselves should, and will, bear the consequences of their actions.

Imposing mandatory election calls may seem an inefficient punishment because it removes from public service politicians with experience and dedication. On the other hand, the induction of new people into politics often brings substantial benefits. New ideas and ways of doing things will replace entrenched powers and symbiotic relationships between politicians and special-interest groups.

Fudging the Books

Creative accounting methods have long been used to lie with statistics and thus alter the apparent health of governments. It seems obvious that future governments will attempt to fudge their books in order to avoid the intent of the constitutional limitations. The most blatant of these methods are to shift expenditure and revenue items between accounting periods, to redefine investment and consumption expenditures, to move activities into and out of the public sector, and to use varying valuation criteria in assessing assets and liabilities.

The use of such creative accounting can be a serious matter. However, its quantitative influence can be limited by the application of a simple rule used by taxation authorities in all countries. Agents can choose among a set of accounting principles and, under certain conditions, such as the opening of a new business, can switch from one to the other. However, once a rule has been adopted, it cannot be changed.

Under such a system, initial opportunities for creative accounting will exist, especially when the constitutional restraint provisions are first made operational. However, within a short period of time these opportunities will disappear and the intent of the restraints will be achieved. The Canadian auditor general can be charged with the policing of the government's accounting system and a judiciary can be made responsible for settling disputes and determining fines and corrective measures.

The Need for Statutes

In economics and politics, nothing is ever quite as simple as it first appears. The preceding discussion shows that the implementation of constitutional limitations on government spending levels and deficits will be a rather complex process. A clear and simple outline of restraint principles in the Constitution will have to be supplemented by a substantial set of statutes for fixing levels and specifying processes through which the intent of the constitutional clause can be realized.

The need for such statutes detracts from the attractiveness of the basic restraint proposals. They will invariably open the gate for the politicization of the restraint program, providing opportunities for politicians to cater to special-interest groups and giving the judiciary the power to influence the outcome of restraint by its decisions. As well, there exists the danger that Parliament might manipulate these statutes to avoid the intent of the restraint provisions. However, this danger can be reduced by the appointment of a permanent panel of independent, quasi-judicial experts responsible for assessing the impact of these statutes and generally overseeing the implementation of the constitutional restraint provisions.[39]

Summary and Conclusions

This study proposes to enshrine in Canada's Constitution clauses designed to limit the level and deficits of the federal and provincial

39 The state of Delaware has created such a panel of independent experts to make economic forecasts that are discussed widely and used by the government in the design of its budgets. Details on the operation and success of this panel are found in Pierre DuPont, "Executive Summary of Delaware's Financial Controls" (Dover, Delaware: Office of the Governor, no date): "Prior to 1977 [the year in which the panel was created], the State had overestimated revenue time and again, in several years by as much as 15 percent. Successful revenue and expenditure forecasting has provided a sound basis for financial decisions. At no time have the revenue forecasts deviated more than two percent from actual collections" (ibid., p. 2).

governments. Violation of these requirements would automatically invoke the dissolution of the responsible legislature and the calling of an election.

This proposal has the potential to reduce excessive spending levels and deficits, thus protecting the economic right of Canadians to the fruits of their labor and investments and eliminating a threat to the democratic system of government. The growth in spending of recent years directly reduces the income of Canadians because it is wasteful and does nothing to raise the efficiency of the economy. This wastefulness is the result of the actions of unethical politicians who cater to special-interest groups in order to obtain their support for upcoming reelections.

Spending deficits crowd out private investment and require ever-increasing rates of taxation, both of which reduce economic growth and burden future generations. Deficit spending seems to be out of control, partly because of powerful special-interest groups and partly because of a breakdown of an historic public stricture of such policies.

Technological innovations that drastically lower the cost of organization and political lobbying have spurred on the growth of special-interest-group power. Only constitutional spending limitations can effectively curb this power by imposing on legislators a budget constraint and, thus, a need to be selective when distributing society's resources.

The demands for Quebec independence and the resulting federal government proposals for the revision of the Constitution have opened a window of opportunity for the inclusion of spending restraints. Quebec separatists have long used the existence of the federal deficit to justify independence. Yet they also oppose, as an infringement of Quebec sovereignty, the proposals of the federal government to coordinate federal and provincial fiscal policies. The adoption of constitutional spending restraints would destroy the validity of the first argument and eliminate the need for the controversial coordination. Thus, constitutional spending limits can be used to further the cause of Canadian unity.

I believe that the relatively minor problems of implementation will not eliminate the merit of the proposed constitutional restraints. The existence and successful operation of such restrictions in the United States suggests that the potential benefits will far outweigh any difficulties, costs, or risks. In all likelihood, these restraints will engender great benefits for Canadian society in the form of protection of economic rights and of the democratic system itself.

Provincial Stabilization Policy: Coordination Issues

William M. Scarth

Introduction

There is a long-standing debate in Canada about the merits of stabilization policy at the provincial level. The recent growth of interest in this debate can be explained by three developments.

First, there are the federal government's proposals for constitutional reform, which involve suggestions for harmonizing macroeconomic policies.

Second, various other proposals concerning the devolution of powers to the provinces have been advanced since the collapse of the Meech Lake Accord. For example, in May 1991, the Western premiers called on the federal government to transfer more taxing power to the provinces so that they could "stimulate their economies in their own ways."[1]

Finally, policy disputes that are quite independent of the constitutional crisis have recently emerged. For example, during the boom of the late 1980s, the Ontario government refused to run budget surpluses. Many analysts have argued that Ontario operated so *pro*cyclically that the Bank of Canada was forced to pursue a more contractionary policy than it would otherwise have done. Inevitably, resentment against Ontario grew among other regions of the country,

1 Stuart Landon and Connie Smith, "Efficiency and Government: Competing Hypotheses of Centralization and Decentralization," University of Alberta Working Paper (Edmonton, June 1991), p. 7.

which believed that Ontario may have been forcing the Bank of Canada's hand in this manner, oblivious to the fact that a disproportionate share of the costs of disinflation would consequently be imposed on these other regions. Resentment against Ontario resurfaced in 1991. The province was now in recession, and its record deficit budget was putting upward pressure on both inflation and unemployment in the rest of the country. As I explain in this paper, if the traditional small, open economy analysis continues to be relevant for Canada, Ontario's expansionary policy can have its desired effect within Ontario only by *worsening* the recession in other provinces.

Given this rekindling of tensions regarding the spillover effects of provincial fiscal policies and given, as well, the federal government's ongoing solicitation of reactions to its constitutional proposals, it seems timely to consider whether any new analytical work has been done that should be brought to bear on policy discussions. With this motivation, I shall devote the remainder of this introductory section of the paper to a brief survey of the main developments in the literature. The second section offers a critical evaluation of one such development and a discussion of some new results. Finally, in the third and fourth sections, I will discuss what coordination means and emphasize the stabilization policy options that offer the best chance of avoiding regional tensions.

The classic article on the analytics of stabilization policy within a federal state is a 1968 paper by Wallace Oates.[2] In that study, Oates presents three arguments leading to the conclusion that stabilization policy is not a suitable activity for junior-level governments.

First, he assumes that each province would be in sync with the rest of the country, in the sense that all provinces have booms and recessions at the same times. This being the case, Oates argued, nothing would be lost by leaving stabilization policy to a central authority, since the purpose of the policy — to stimulate or to

2 Wallace E. Oates, "The Theory of Public Finance in a Federal System," *Canadian Journal of Economics* 1 (1968): 37–54.

contract aggregate demand — would be the same wherever it was conducted.

Second, an important feature of the models Oates considers is that the "marginal propensity to import" is very high for all provinces, so that the "multiplier" effect from junior-level stabilization policy is quite small.

Third, Oates stresses that even in the absence of this traditional feature of static Keynesian analysis, the provincial-level multiplier would be very small because of the debt-accumulation process that follows from bond-financed fiscal policies. Compared with the government debt issued to finance the federal deficit, a much higher proportion of the debt issued to finance provincial deficits is "foreign"-owned — since, in this case, "foreign" refers to both the rest of the world *and* the rest of the country; hence, the lasting implication of the buildup of provincial public debt is a large reduction in the province's "domestic" wealth. With perfect capital mobility — which is a particularly appealing assumption at the provincial level — this foreign-debt accumulation occurs very quickly. In Oates' model, private consumption is pulled down by the reduction in the net worth of domestic residents by just about the same amount that aggregate demand is stimulated through the higher government spending. This is an application of the wealth-based "crowding-out" effect, and Oates argues that it very much undercuts the viability of provincial-level stabilization policy, no matter how high the province's marginal propensity to import.

Since the publication of Oates' article, many analysts have accepted the view that stabilization policy should remain the preserve of the federal level of government. Nevertheless, there have been some dissenting views. These are well summarized in Yves Rabeau's background study for the Macdonald Commission.[3] Rabeau notes that a number of empirical analyses of regional multipliers in Canada have

3 Yves Rabeau, "Regional Stabilization in Canada," in John Sargent, ed., *Fiscal and Monetary Policy*, Collected Research Studies of the Royal Commission on the Economic Union and Development Prospects for Canada 21 (Toronto: University of Toronto Press, 1986).

generated estimates that are noticeably larger than what Oates' analysis predicts. Indeed, the provincial-level multiplier is often estimated to be a full 80 percent of the size of the comparable federal-policy multiplier, particularly in the case of the larger provinces. But these numerical estimates are based on models that are very much open to the rational-expectations critique. Modern analysts demand that an economic model involve well-informed agents whose purposeful behavior is well explained and whose objectives — *not* their decision rules — are policy-invariant. Perhaps because of this criticism, many analysts have remained skeptical of provincial-level fiscal policy, despite the fact that the estimated policy multipliers for junior-level governments are noticeably larger than Oates predicts. Perhaps the difficulty in achieving coordination among the many provincial governments is another reason many analysts have remained unenthusiastic about provincial stabilization efforts.

Some writings that represent a more significant challenge to Oates' view have appeared since Rabeau prepared his study for the Macdonald Commission. Edward Gramlich argues that four major changes in Western economies have significantly strengthened the case for provincial-level stabilization policy,[4] and Tom Courchene has shown that all four are relevant for Canada.[5] These developments are reflected in the following four propositions:

Provincial cycles are not always positively correlated. Many business cycles at the regional level are now caused by relative price shocks, not simply by changes in aggregate demand that have similar effects on all regions. For example, while the dramatic lowering of energy and farm product prices was a major cause of the economic downturn in the Canadian West in recent years, it had no such effect in

4 Edward M. Gramlich, "Canadian Fiscal Federalism: An Outsider's View," in Melville McMillan, ed., *Provincial Public Finances*, vol. 2, *Plaudits, Problems and Prospects* (Toronto: Canadian Tax Foundation, 1991).

5 Thomas J. Courchene, "Rethinking the Macro Mix: The Case for Provincial Stabilization Policy," in Robert C. York, ed., *Taking Aim: The Debate on Zero Inflation*, C.D. Howe Policy Study 10 (Toronto: C.D. Howe Institute, 1990).

Central Canada. Gramlich predicts that, increasingly, some regions will want to stimulate economic activity at the very time that others want to dampen demand; federal government policy that does not make significant distinctions across regions will therefore no longer be adequate. According to this argument, then, the fundamental causes of business cycles are different from what they used to be.

A larger service sector means lower provincial imports. The second change that Gramlich identifies is the increase in the size of government policy multipliers at the provincial level, caused by the dramatic shift in employment in all regions toward the service sector. Since services are largely nontraded goods, the provinces' "marginal propensity to import" is falling. By standard Keynesian reasoning, this structural change raises the spending multipliers.

Government bond issue at any level raises foreign debts. The third development is that, because perfect capital mobility applies increasingly to countries *as a whole*, debts incurred through fiscal policies undertaken at the federal level create just as much of a foreign-debt service problem for private residents as do debts incurred at the provincial level. This reasoning suggests that wealth-based crowding-out effects should be no more severe at the provincial level than at the federal level.

Fiscal policies work best under fixed exchange rates. Gramlich's fourth point builds on the classic small, open economy analysis of Robert Mundell and J.M. Fleming.[6] Since the publication of Oates' writings, the world has moved to a floating exchange-rate system, so that fiscal policies undertaken within a small open economy — let us say, at the federal level — are largely irrelevant for aggregate demand, since they simply lead to export crowding-out. Gramlich stresses that

6 Robert A. Mundell, "Capital Mobility and Stabilization Policy under Fixed and Flexible Exchange Rates," *Canadian Journal of Economics and Political Science* 29 (1963): 475–485; J. Marcus Fleming, "Domestic Financial Policies under Fixed and under Floating Exchange Rates," *International Monetary Fund Staff Papers* 9 (1962): 369–380.

because the Group-of-Ten "countries" (in Canada's case) at the provincial level are still on a fixed exchange-rate system, fiscal policy at the provincial level must retain some effect on aggregate demand. Indeed, according to this argument, fiscal policy multipliers at the provincial level could be expected to be *larger* than those that now apply to federal government initiatives. To test this conjecture, I shall refer to a specific model in the next section of this paper.

Although Gramlich's propositions undercut Oates' arguments against provincial-level stabilization policy, further investigation is necessary to evaluate their real importance. To keep this paper within its space constraint, I shall concentrate on the fourth proposition, providing a detailed investigation of it in the next section. In closing this introductory section, however, I offer a passing comment on each of the other three points.

Concerning the importance of relative price disturbances, I have no argument. Indeed, back in 1961, Robert Mundell wrote in an article on optimal currency areas that when the borders of nation states and the boundaries of economic regions — areas characterized by free internal but little external factor mobility — do not coincide, there is a need for some initiative such as regionally separate fiscal policies.[7] In addition to a flexible exchange rate at the national level, (which is necessary to maintain an independent inflation policy), additional measures are necessary to maintain internal balance in each region. I view Gramlich's first proposition as simply stating that the applicability of Mundell's insight has increased in recent times. Also, I expect that Gramlich's second point — that the nontraded goods sector is now much larger — is one of the main reasons that recent empirical studies have found provincial fiscal multipliers of significant magnitude. In short, I find nothing controversial about Gramlich's first two points.

I would caution analysts not to accept Gramlich's remaining two propositions, however, without further close consideration.

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7 Robert A. Mundell, "A Theory of Optimum Currency Areas," *American Economic Review* 51 (1961): 657–665.

With regard to the third point, concerning foreign-debt-service obligations, recent work by Ronald Kneebone shows that when this idea is pursued, important issues concerning *dynamic convergence* are raised.[8] For example, the stability conditions that must pertain in a federal state to keep the debt-to-GDP ratios from exploding are noticeably more stringent than those required in an otherwise similar system that involves only one level of government. This is so because there are important feedbacks between the two levels of government budget constraints. For example, a cut in federal government spending — undertaken to eliminate a budget deficit at that level — lowers the tax base of the provinces, and so widens budget deficits at the provincial level. Macroeconomic stability with constant debt-to-GDP ratios is still possible, but it is less likely when more than one level of government is running bond-financed deficits. One of Kneebone's results is that the stringency of the convergence requirements is significantly eased if either the federal government or the provinces balance their budget. Given Kneebone's analysis, which extends Oates' work formally by focusing on the *dynamics* of foreign indebtedness, I recommend skepticism concerning Gramlich's conjecture that bond-financed budget deficits at both levels of government are now viable. Policy analysts will have to conduct a series of sensitivity tests of Kneebone's results to assess their general applicability, before the implications of the foreign-indebtedness effects — on which Gramlich wishes to focus — can be properly evaluated.

Finally, we come to Gramlich's fourth point. Gramlich suggests that since a province is a small, open economy with a fixed exchange-rate relationship with the rest of the country — a significant part of the rest of world, from the province's point of view — and since the whole country is a small open economy with a flexible exchange-rate relationship with the rest of the world, there will be less crowding-out of fiscal policies at the provincial level than at the federal level. Luckily, there is a straightforward way to evaluate this proposition.

8 Ronald D. Kneebone, "On Macro-economic Instability under a Monetarist Policy Rule in a Federal Economy," *Canadian Journal of Economics* 22 (1989): 673–685.

Since there exist formal models that contain this level of regional disaggregation, we can simply summarize and extend them. It is to this task that we now turn.

Stabilization Policy Options within a Currency Union

Spurred on by the economic integration that is proceeding in Europe, some open-economy macroeconomists have recently studied the stabilization policy options for small individual states within a currency union. For example, Jay Levin and, more recently, Thomas Moutos and I have modeled two small countries within a currency union.[9] These studies consider a fixed exchange rate between the member countries, a flexible exchange rate between the currency union and the rest of the world, and an integrated world capital market that pegs the interest rate for the entire currency union. Levin assumes fixed prices, but Moutos and I provide sensitivity testing of the results by considering various specifications for both price and wage changes, which allow for supply-side effects of the exchange rate. A simple version of these models is given in the appendix to this chapter, and it is assumed that the interested reader can use it to verify statements made in the following discussion. (Space constraints and the policy-oriented focus of this article preclude the inclusion of the formal derivations here.)

For the present study, I have considered two extensions to the work noted above. First, I have considered fixed exchange rates throughout — that is, both within the currency union and between the currency union and the rest of the world. The motivation for this extension is to determine whether the nature of the spillover effects — the effects of one province's stabilization policies on the economy

9 Jay H. Levin, "A Model of Stabilization Policy in a Jointly Floating Currency Area," in J.S. Bhandari and B.H. Putnam, eds., *Economic Interdependence and Flexible Exchange Rates* (Cambridge, Mass.: MIT Press, 1983); Thomas Moutos and William Scarth, "Stabilization Policy within a Currency Area," *Scottish Journal of Political Economy* 35 (1988): 387–397.

of a neighboring province — is affected by the federal government's monetary policy. We find that alternative central bank policies can have important effects, meaning that we are able to draw conclusions about what the federal government might do to reduce regional tensions *without* having to make any constitutional change.

The second extension to the existing literature on currency unions that I have considered here is the use of provincial sales tax rates as the instrument for pursuing independent stabilization policy. Important differences are found to exist between sales tax rates and levels of provincial government spending as stabilization policy instruments: with government spending, the spillover effects across provinces are positive under fixed exchange rates but negative under flexible exchange rates; with sales tax changes, the spillover effects can be (and likely are) positive no matter which central bank policy is followed. The conclusion is that as long as provincial stabilization policy is conducted via sales tax changes and as long as positive spillover effects across provinces are deemed desirable, a lessening of regional tensions may be possible without constitutional change *or* adjustment in monetary policy. But the desirability of discretionary policy in general and of positive regional spillover effects in particular is a matter of some controversy, so I shall return to these issues in the following section.

To facilitate the explanation of the results, and of the properties of this class of fiscal policy models, I shall call the two states within the currency area "Quebec" and "Ontario," and the entire currency area "Canada." I consider an expansionary fiscal policy in Ontario — choosing Ontario in an attempt to convince a reader in the early 1990s of the direct applicability of this analysis — and ask whether this policy causes an expansion or a contraction in Quebec. While a fixed exchange rate is maintained between Quebec and Ontario throughout the analysis, I consider both flexible and fixed exchange rates between Canada and the rest of the world.

If Canada has a flexible exchange-rate relationship with the rest of the world, and Ontario brings down an expansionary budget, then the increase in government spending in Ontario will have two effects

on aggregate demand in Quebec. The first is the direct trade-linkage effect: higher incomes in Ontario mean that Ontario buys more of Quebec's exports, thereby stimulating economic activity in Quebec. The second is the exchange-rate effect: the Ontario expansion brings pressure for higher Canadian interest rates and, hence, for a higher value of the Canadian dollar. A more expensive dollar decreases net exports throughout the country, including Quebec. The model given in the appendix shows that this second effect must dominate in Quebec, so that while Ontario's level of economic activity must rise as a result of its expansionary policy, economic activity in Quebec *must* fall. Thus, provincial fiscal policy does "work," as Gramlich and others now argue, but it works precisely because it is a beggar-thy-neighbor policy.

Now consider the same fiscal policy undertaken within Ontario when Canada has a *fixed* exchange-rate relationship with the rest of the world. In this context, the second effect described above simply does not occur. Instead, the pressure for higher domestic interest rates brought on by Ontario's fiscal expansion results in a temporary balance-of-payments surplus and, hence, in an increase in the overall Canadian money supply. This expansionary mechanism reinforces the direct trade-linkage effect: since both influences stimulate economic activity in Quebec, the spillover effect from one province to the other is positive, not negative.

So, provincial-level fiscal policy works — for the province that initiates it — no matter which exchange-rate regime is imposed at the federal level. Sometimes provinces will want negative spillover effects — if their business cycles are out of sync — in which case a floating exchange-rate regime will be desired. But the cycles in provincial economic activity will often essentially coincide; at such times, a fixed exchange-rate regime will be preferable, if beggar-thy-neighbor effects are to be avoided.

Perhaps the most general point to follow from this analysis is that we cannot come to a summary view about the wisdom of encouraging provincial-level stabilization policy until two issues have been clarified. First, do we want the spillover effects to other

provinces to be positive or negative — that is, are provinces' business cycles in or out of sync? Second, how likely is it that the federal government (and the central bank) will continue to opt for a floating exchange-rate policy? As noted above, it seems likely that, on many occasions, we would answer that the business cycles across regions are positively correlated and that the Bank of Canada is steadfast in its determination to conduct an independent monetary policy. If this assessment of the state of the world is accurate, then we may too often find ourselves in the awkward position of wanting positive spillover effects from provincial expenditure policies but having to accept negative ones.

There are two ways around this dilemma. One is to argue that the central bank can afford to switch to a fixed exchange-rate policy without giving up on a low-inflation target. The other is to find another instrument for stabilization policy at the provincial level — one that would involve positive spillover effects regardless of the prevailing exchange-rate regime. We now consider each of these options in turn.

An Alternative Monetary Policy

Current monetary policy is based on mainstream macroeconomics. Within this "natural-rate" analytical framework, nominal variables can affect real variables only in the short run. In view of this, the Bank of Canada should leave employment objectives to some other instrument of policy, and instead concentrate exclusively on controlling the underlying inflation rate by ensuring that monetary growth is limited. Since, in a market-oriented economy, the authorities cannot control both the price and the quantity of anything (including money), this proposition naturally leads to support for a flexible exchange rate, which allows for independent control of money growth.

It is not my purpose here to challenge the view that the Bank of Canada should be trying to limit inflation. Since I take this general goal to be uncontroversial, nothing I suggest in this paper requires a rejection of that view. But there is significant debate as to whether

precisely zero or a low positive rate of inflation — say, about the amount that the United States now seems prepared to tolerate — is more appropriate at this time.[10] If analysts emerge from this zero-inflation debate with the view that the modest, close-to-zero, U.S. inflation rate is an appropriate goal, then a fixed exchange-rate policy can ensure that we meet our inflation objective. There is some risk in this approach, of course, since the U.S. Federal Reserve may not continue to resist significant inflation at some point in the future. Should this occur, however, Canada can always return to a flexible exchange rate.

I cannot pretend to give a thorough treatment of the choice between a fixed and a flexible exchange-rate policy here; each alternative has several advantages. For example, a flexible exchange rate can provide the economy's real variables with better insulation from real disturbances in the rest of the world, while fixed exchange rates can lead to lower transaction costs and lower interest rates — through lower-risk premiums. I wish to stress only two points. First, the feature of a flexible exchange rate that is often perceived as its fundamental advantage — inflation control — would *not* be lost if the value of the Canadian dollar were pegged to the value of the currency of another country in which the central bank was behaving responsibly. Second, by moving away from flexible rates, we could benefit from a feature of fixed exchange rates that may be deemed an advantage: positive rather than negative spillover effects across provinces from government-expenditure changes. One of my motivations in writing this paper is to emphasize this potential advantage of fixed exchange rates, which I have found not to be widely appreciated. And, while I do not wish to recommend a fixed exchange-rate policy without reservation — that is, without further consideration of the other pros and cons of flexible exchange rates — I do want to stress that the combination of current U.S. monetary policy and existing regional tensions within Canada may make the case for fixed exchange rates stronger now than it has been for some time.

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10 See York, ed., *Taking Aim.*

Bank of Canada Governor John Crow has argued that "sound money is an investment in the economic well-being of the nation."[11] But if the United States is committed to a sound money policy as well, then a fixed exchange-rate policy in Canada might deliver the same economic well-being, and might simultaneously represent an investment in the *political* well-being of the nation — by turning negative provincial spillover effects into positive ones.

Any discussion of policy alternatives raises the issue of the distribution of political power. Policy change is not likely to occur in the absence of either some new understanding of the costs and benefits involved or a real desire to transfer power. A shift to fixed exchange rates would involve a shift in power, but not quite the usual one — that is, from the federal government to the provinces. Rather, the federal authorities — and, indeed, the country's citizens — would simply give up the power to determine the inflation rate, since the world — that is, the U.S. — inflation rate would have to be accepted. By giving up that power, the federal authorities would ensure a gain at the provincial level: provincial stabilization policies would no longer simply cancel one another out, since the spillover effects across provinces would become positive instead of negative. In short, while the Bank of Canada cannot hand over to the provinces the ability to conduct monetary policy, it can change the provinces' options for conducting their own fiscal policy.

Although the "transfer" of power just described requires no constitutional change, exchange-rate policy is based on a wider set of issues, and I suspect most readers would argue that a major change in this area is neither likely nor, perhaps, desirable. This prediction is particularly appropriate in the light of the federal government's September 1991 proposal that the inflation-only mandate for the Bank of Canada be included in new legislation. It is important, therefore, to identify other provincial policy instruments

11 John W. Crow, "Some Monetary Policy Basics" (Notes for remarks by the Governor of the Bank of Canada at the B.C. Children's Hospital breakfast meeting for the financial community, Vancouver, April 3, 1991); reprinted in *Bank of Canada Review* (April 1991), pp. 27–32.

that might involve positive spillover effects regardless of the prevailing exchange-rate regime.

An Alternative Fiscal Policy

Thus far, I have considered only one provincial policy instrument: the overall level of spending on goods and services. I now consider instead a cut in the provincial sales tax as a method for stimulating local economic activity. (For the purpose of illustration, I shall once again assume that the policy is being undertaken in Ontario.) A reduction of the sales tax in Ontario expands economic activity within the province by stimulating aggregate demand in two ways: (1) by raising household expenditures directly, and (2) by lowering the price index and thereby raising the real value of the money supply. Other things being equal, this extra liquidity creates pressure for lower domestic interest rates and, under a flexible exchange-rate regime, for a lower value of the Canadian dollar. A depreciation of the domestic currency stimulates net export demand.

Now consider what happens in the rest of the country. Demand in Quebec is stimulated both through the standard trade-linkage effect with Ontario and because a cheaper Canadian dollar stimulates net exports for *all* regions, not just Ontario. With a policy of sales tax reduction, then, the exchange-rate effect can *support* the trade-linkage effect, rather than work against it, as far as demand in the rest of the country is concerned. The main reason for this difference *vis-à-vis* government expenditure changes is that the tax rate has both a goods-market effect and a *direct* influence in financial markets — because it directly affects the price level. By contrast, changes in government purchases have a direct effect only through the goods market.

It must be remembered, however, that the value of the Canadian dollar does not necessarily fall after a cut in the Ontario sales tax. This outcome occurs only if the increase in the real supply of money exceeds the additional transactions demand for money, causing the net pressure on interest rates to be in the downward direction. Thus, with money-supply targeting, as a matter of pure theory, we cannot

be sure that the spillover effect from the Ontario tax cut is expansion in Quebec. Nevertheless, this outcome is at least possible with this instrument, and the reader can verify — by manipulating the model specified in the appendix — that for any reasonable set of parameter values, the spillover effect to Quebec is positive, not negative.[12] Furthermore, with a direct price-level targeting policy on the part of the central bank, the positive spillover effect is guaranteed for *all* admissible parameter values. Thus, with this (most relevant) version of the flexible exchange-rate analysis, and with a fixed exchange rate, there is no ambiguity at the theoretical level: the sales tax cut in Ontario must raise economic activity in both regions no matter which exchange-rate regime is in place.

Thus, as long as we assume that the provinces' business cycles are positively correlated and that positive spillover effects from provincial stabilization policies are therefore desirable, the sales tax is the better policy instrument for a province to use. Unlike government spending, sales tax policies are likely to be free of beggar-thy-neighbor effects regardless which exchange-rate policy is adopted by the federal government and the central bank. Since the Bank of Canada seems determined to maintain an independent inflation policy — and therefore a floating exchange rate — provinces should concentrate on temporary sales tax changes as their main stabilization instrument.

There is another argument that favors the sales tax as the best stabilization policy instrument (for both levels of government). Like many models that are used for direct policy analysis, the simple system listed in the appendix makes no reference to expectations effects. Yet, we must consider whether the effectiveness of the policy would be undermined if private agents fully anticipated the policy-maker's manipulations and then acted on those expectations. After all, business cycles keep recurring, and if the authority is committed to an ongoing stabilization policy, then the changes in the fiscal-

12 Many sensitivity tests are derived in an unpublished working paper that is available from the author on request. The tests include such issues as alternative scale variables in the money-demand function and alternative degrees of wage and price flexibility.

policy instrument *must* be temporary. Does that very fact, when it is recognized by private agents, render the policy ineffective?

It has long been recognized that expectations effects do fundamentally undermine the attempt to use temporary *income tax* changes to affect aggregate consumer expenditures. Since most households base their expenditures on their average (expected) income, short-run variations in income that do not affect that average have very little impact on spending. (Many households use savings as a short-run buffer to insulate their level of consumption from purely temporary variations in receipts.) Thus, the more temporary are changes in the income tax rate, the more irrelevant they become for stabilization policy purposes. But the same stricture does not apply to temporary *sales tax* changes. In this case, the more temporary the changes, the *more* it pays households to alter the timing of their replacement expenditures on durables, and so the more successful the policy is in shifting the timing of spending.

One other implementation issue worth mentioning in this assessment of alternative fiscal policy instruments is the question of implementation lags. Yves Rabeau notes that these lags have been relatively short for temporary sales tax changes.[13] Stanley Winer argues that federal government initiatives will likely involve much longer implementation lags in the future if constitutional changes fundamentally increase the power of the Senate.[14] If Winer's prediction turns out to be true, the case in favor of conducting stabilization policy at the provincial level via temporary changes in sales tax rates may be stronger.

What Does Coordination Mean?

Finally, we must consider the quite general issues of whether a discretionary fiscal policy should be adopted at all, and, if so, whether

13 Rabeau, "Regional Stabilization," p. 181.

14 Stanley L. Winer, "A Brief Introduction to Longer Run Issues in the Conduct and Design of Fiscal Policy in Canada," Carleton University Working Paper (Ottawa, June 1991).

positive or negative spillover effects are desirable. In recent years, numerous studies — such as the one undertaken by Robert Barro and David Gordon in 1983[15] — have shown that a passive government policy may be the best option. In these "natural-rate" models, once the stabilization policy authority demonstrates that it is willing to exploit the temporary commitments of private agents in an attempt to affect unemployment in the short run, the private agents take this government behavior into account, and the result is pressure for higher inflation in the longer run. These analyses have led many commentators to favor the rejection of an activist stabilization policy at *either* the federal or the provincial level of government. Three comments are warranted on this topic, and I devote a short section to each.

Ongoing Rules versus Discretionary Policy

At the conceptual level, as long as policy is set in the form of an *ongoing rule* that involves *balancing the budget* over the cycle, it is possible to increase the built-in stability properties of an economy *without* causing long-term inflation, despite the Barro-Gordon concern. It must be remembered, however, that this argument — which defends a *predictable* policy rule — is not one that can be used as an underpinning for what many commentators mean by a "discretionary" fiscal policy. But even if one is opposed to discretionary policy, as long as one believes that some provinces can and will undertake such actions, one must establish a position on whether positive or negative spillovers across provincial boundaries are desirable.

Actual Fiscal Policymaking

Policy analysts explain many actual government spending decisions (at all levels) in terms of short-run political gain, often criticizing

15 Robert J. Barro and David B. Gordon, "Rules, Discretion and Reputation in a Model of Monetary Policy," *Journal of Monetary Economics* 12 (1983): 101–121.

them as working against stabilization policy objectives. Analysts who adopt such views — which are perhaps more realistic than cynical — should favor an *uncoordinated* set of provincial fiscal policies, counting on the odds that at least some percentage of these "random shocks" will be correct from a macroeconomic perspective. Such views also suggest that, if actual fiscal policies are often "wrong" — that is, procyclical — and if provincial business cycles are in sync, negative spillover effects will be desirable. In this case, at least, other provinces would be helped rather than hurt by the perverse policy initiatives of their neighbors. While I acknowledge the benefit of negative spillovers here, most of this paper has been written from the point of view that provincial policies will not be severely procyclical in the future. This hope is based on the federal government's proposal that budget making by all governments be more open, better coordinated, better harmonized with monetary policy, and monitored by an independent agency.

Positive versus Negative Spillovers

In the end, whether we regard positive or negative spillovers as desirable or undesirable depends largely on the answers to the following two questions: Will the various provincial business cycles be in sync? and, Will policymakers behave countercyclically? The four possible answer patterns and the corresponding verdicts regarding the desirability of positive or negative spillovers are outlined in the table on the following page.

The possibilities indicated in the table make it clear that a "coordinated" policy may be difficult to define. For example, a unilateral increase in government spending in a province that is in recession is an example of a coordinated policy if other provinces are also in recession and Canada has a fixed exchange rate. This same policy is an uncoordinated, beggar-thy-neighbor initiative if other provinces are in recession but Canada has a flexible exchange rate. It is difficult to know whether we should support the coordination called for in the federal government's September 1991 proposals

Table 1: ***Positive versus Negative Spillovers***

Provincial Economies in Sync	Policy Is Countercyclical	Nature of Spillover Desired
yes	yes	positive
yes	no	negative
no	yes	negative
no	no	positive

without some assurance that the term will be applied in the sort of case-specific manner that these examples make clear is necessary. As noted earlier, those who are skeptical of the degree of precision that can be achieved by actual fiscal policies will likely reject the call for "coordination" that must be considered in such very specific terms in order to be properly defined.

Conclusions

There is no doubt that the Bank of Canada is committed to bringing inflation down to a very low rate. Although this goal might be achieved by pegging the exchange rate — assuming that the United States is successful in its fight against inflation — the Bank is convinced that, over the longer term, it will prove to be a more credible inflation fighter than the Fed. Whether or not this view is correct, it seems sensible to assume, in any realistic discussion of provincial-level stabilization policy, that a flexible exchange-rate policy would be a given. Taking into account this and other constraints,[16] I have argued that temporary sales tax changes represent the policy best suited for short-run stabilization. Either level of government can use this policy instrument. With the GST now in place, the federal government is finally in a position to conduct such a fiscal policy at

16 Such as the constraint imposed by the rationality of private sector expectations, and the variable length of lags involved in implementing the different fiscal policy instruments.

the national level. Also, if sales tax changes are initiated at the provincial level at the proper phase in the business cycle and the regional cycles are in sync, coordination problems should be minimized, since the spillover effects involved are likely to be positive.

My specific analytical results have, of course, been based on the assumption of perfect capital mobility; if this assumption is relaxed, it is found that the spillover effects of provincial government spending policies can change from negative to positive. The emphasis on sales tax policy follows from two considerations: (1) the perfect-capital-mobility assumption seems a reasonable approximation for Canada, and (2) even if capital mobility is not perfect, we wish to identify which policy instrument involves the least "risk" of having unintended spillover effects.

As noted above, one unresolved issue in all of this is that sanctioning stabilization policy at the provincial level may make it more difficult to keep the country's policymakers focused on the long-run deficit dynamics. As explained earlier, the longer-run foreign-debt-servicing problems become much more severe when both federal and provincial levels of government are running bond-financed deficits. A vicious circle can easily develop: high levels of interest payments on the debt force all levels of government toward further deficits and bond issue, causing interest-payment obligations to continue to rise (as a fraction of total income). Is there any way we can allow the provinces flexibility in the short run (to conduct stabilization policy), while simultaneously imposing on them the constraint that they must balance their budgets (in a growth sense) over the time interval of each business cycle?

The federal government's September 1991 constitutional proposals suggest such a balancing of budgets over the cycle, but they do not indicate specifically how this behavior might be encouraged. Some analysts have suggested following the institutional arrangements of other countries. The Australian Loans Commission, for example, constrains the amount of bond issue permitted by state governments. Similarly, to be admitted to the European Monetary System, a country must meet specific numerical limits on its debt-to-

GDP and deficit-to-GDP ratios. These arrangements are definitely worthy of study, since the existing political process in Canada is ill-suited to deficit control — considering, especially, that different levels of government do the bulk of spending as compared to taxing, and that current government-expenditure programs benefit almost two-thirds of the electorate.

Are institutional/constitutional limitations on deficits more appropriate at the federal or the provincial level? The historical record suggests clearly that the problem of control has been more severe at the federal level. The recent federal spending caps are a welcome development, but, as William Mackness has argued, the time may be past for such a "gradualist" approach.[17] The provinces, by contrast, cannot print money and lack taxing power at a national level; these significant, built-in constraining forces have kept provincial governments reasonably prudent with regard to deficits and debt.

This tendency could be reinforced, without the need for any constitutional change, by having the federal government reinstate conditional grants to provinces. While it is true that, except for the Canada Assistance Plan, conditional grants were phased out in 1977 and that the federal government was severely criticized for trying to influence provincial decisionmaking by means of those grants, political resistance might not accompany the following scheme in the same degree. Suppose the general level of a province's unconditional grant were adjusted up or down every few years, depending on whether or not that province was being fiscally prudent — in the sense of balancing its budget over the cycle. This policy would not interfere with a province's right to decide its spending priorities, but it would discourage the province from systematically imposing external costs on the rest of the country by consistently running deficits in the name of *short-run* stabilization policy. (A province that received no equalization payments would need to have some similar financial incentive, such as a lump-sum transfer of some tax revenue in one direction or the other, again depending on the province's

17 William Mackness, "Big Government and the Constitution Crisis," *Fraser Forum* (December 1991).

overall level of fiscal prudence — *not* on its preferences regarding particular spending priorities or the overall size of its government sector.) For credibility, of course, the federal government would have to display fiscal prudence itself — of the sort that it has failed to demonstrate during the past 20 years.

Despite the speculative nature of these last remarks, I hope that this paper can make a positive contribution to the national-unity debate. I have drawn attention to a policy that can alleviate the negative spillover effects that are otherwise prone to follow from provincial-level stabilization policy. Furthermore, I have emphasized that the successful use of this instrument requires neither constitutional change nor an alternative monetary/exchange-rate policy.

Appendix

The following equations define a simple aggregate-demand model — Jay Levin's system,* with the addition of a sales tax in one region — which can be used to verify all the results discussed in the second section of the chapter:

$$Y_1 = C^1[Y_1/(1+S)] + G_1 + B[Y_1/(1+S), Y_2] + T^1[E, Y_1/(1+S)];$$

$$Y_2 = C^2(Y_2) + G_2 - B[Y_1/(1+S), Y_2] + T^2(E, Y_2);$$

$$M = (1+S)L^1(Y_1) + L^2(Y_2).$$

The variables are defined as follows: B is region 1's net exports to region 2; C is total private expenditures; E is the exchange rate — defined as the value of foreign exchange; G is government expenditure on domestic goods; L is demand for money; M is the money supply of the entire country; S is the sales tax rate imposed in region 1; T is net exports with the rest of the world; Y is real output. The 1 and 2 sub- and superscripts denote the two regions. Parameters are defined by the derivatives of the behavioral functions — shown by subscripts — and the assumptions about the parameters are:

$$0 < B_2, C_1^1, C_1^2 < 1;$$

$$T_1^1, T_1^2, L_1^1, L_1^2 > 0;$$

$$0 > B_1, T_2^1, T_2^2 > -1;$$

$$-B_1, -T_2^1 < C_1^1; \text{ and}$$

$$B_2, -T_2^2 < C_1^2.$$

Readers are encouraged to use this information to verify the results that were discussed in the body of the paper. All policy

* Levin, "A Model of Stabilization Policy."

multipliers (except dY_2/dS) can be signed without making quantitative assumptions. One set of sufficient — though not necessary — conditions for dY_2/dS to represent a positive spillover effect is: (1) that region 1's overall marginal propensity to import (from the rest of the country *and* the rest of the world) exceed one-half, and (2) either that its income elasticity of money demand be unity or that the country's central bank be pegging nominal income. A more technical working paper is available on request from the author. It contains all these derivations, and a series of sensitivity tests that generalize this system. Sometimes, a few more quantitative assumptions are needed in the more general analysis. On the other hand, some extensions make the analytical results more definite. For example, if, under flexible exchange rates, the central bank pegs the price level rather than the money supply — as the Bank of Canada now explains is its current operating procedure* — the third equation above is replaced by:

$$z_1 (1 + S) P_1 + z_2 P_2 + (1 - z_1 - z_2) E = \text{constant},$$

where the zs are CPI weights. With constant marginal costs (*P*s), this equation implies $dE/dS < 0$, so that the model definitely predicts $dY_2/dS < 0$, without any quantitative assumptions being made.

* See *Bank of Canada Review* (September 1991).

Growth and Stabilization Burdens of Government Policy Failures: *A Comment on Grubel and Scarth*

Douglas D. Purvis

The two papers by Herb Grubel and Bill Scarth focus on distinct but related aspects of government policy. Grubel is concerned with the long-term implications of recent trends toward increased government spending, taxes, and deficits. Scarth is concerned with the shorter-term issue of stabilization policy. The common thread is that both are aware of the "coordination" problem arising from the interactions of the policies of the federal and provincial governments. A further common thread, in my mind, is that any prescription for, or evaluation of, fiscal policy must involve a weighing of short-run stabilization and long-run prudence.

To set the stage for my remarks on these papers, it might be useful to describe some broad patterns in the recent history of fiscal policy in Canada. The most obvious characteristic, of course, is that since 1975 Canada has experienced a persistent, large federal deficit, unprecedented in peacetime, that resulted in the accumulation of a national debt of over $400 billion by 1992. In exploring the genesis of that experience, it is useful to focus first on the years 1975 through 1985:

- Over this period, the growth in the deficit was almost entirely federal, and arose through increases in the primary structural deficit; this, in turn, reflected roughly constant government

This comment was written while I was a Visiting Scholar in the Department of Economics at McGill University. I would like to express my appreciation for the hospitality shown to me during my visit.

expenditure and falling taxes — each expressed as a share of gross domestic product (GDP).[1]

- Provinces tended to balance their budgets over this period, but they also made up any tax room created by the federal government. Thus, their spending and tax revenues increased together. (A notable exception was Alberta, which, through its Heritage Fund, had saved some of the fiscal dividend arising from its energy sector.) Thus, while the provinces contributed little to the consolidated deficit position of Canadian governments, the provinces tended to convert the federal pattern of constant expenditure and falling taxes to a consolidated government pattern of rising expenditure and constant taxes — again as a share of GDP.
- From a stabilization perspective, the federal government actively attempted to use its budgets to stabilize the economy, although the record about the overall effectiveness of these attempts is quite mixed. The provinces, through their tendency to balance their budgets, tended to be procyclical — that is, to accentuate cyclical fluctuations.

The post-1985 period differs in a number of respects. The federal government introduced a series of budgets that focused primarily on the medium-term evolution of the debt-to-GDP ratio, eschewing stabilization policy — or at least de-emphasizing it relative to the previous decade. This led to cuts in government program expenditure and to tax increases. The debt-service component of the deficit ballooned, however, thus forestalling any fall in the deficit or decline in the debt-to-GDP ratio. While the federal deficit stabilized, provincial deficits started to grow. In fact, over this period the

1 See, for example, the tables in the federal government's September 1991 constitutional proposals, reproduced in Grubel's paper; and Pierre Fortin, "Federal Debt Trends in Perspective: Causes, Prospects, and Implications," in Martin F.J. Prachowny, ed., *Policy Forum on the February 1990 Federal Budget* (Kingston, Ont.: John Deutsch Institute for the Study of Economic Policy, Queen's University, 1990).

provinces were the major source of increases in the consolidated government deficit.

The increased provincial deficits did not necessarily reflect an end of the procyclical nature of provincial fiscal policies. For example, the Ontario Liberal government of David Peterson introduced large spending increases and sustained big deficits, creating significant stimulus during the boom period of the late 1980s, leaving to the NDP government of Bob Rae the need to introduce fiscal restraint during the 1991–92 recession. Furthermore, part of the increase in provincial deficits results from federal restraint with respect to transfers to the provinces as part of the federal deficit control strategy; from the perspective of the consolidated government deficit, this shifts the location of the deficit but does not necessarily reduce it.

These episodes illustrate a fundamental problem with the nature of fiscal policy in Canada: the lack of coordination of the activities of the various levels of government. This problem occurs with respect to a variety of issues in addition to the fiscal stabilization and prudence objectives highlighted above:

- Conflict over shared-cost programs and the use of the federal spending power.
- Overlap and duplication in many programs. This is not only wasteful but it also leads to a sense of lack of accountability and, indeed, alienation of citizens from their governments.
- Provincial budgets that often undo or undermine federal initiatives — sometimes intentionally and sometimes accidentally. An oft-cited example is the cutback in provincial welfare programs that followed increases in the federal low-income tax credits in the early 1980s.
- Capital markets and financial institutions that face a quagmire of overlapping and sometimes inconsistent federal and provincial regulations. These inhibit capital mobility and weaken Canada's international competitiveness.

First ministers' conferences, finance ministers' meetings, and numerous meetings of officials have attempted to address these problems,

but with limited success at best. As often as not, they have served only to increase acrimony and frustration; they seldom resolve fundamental issues.

There is broad agreement that the economic policies of the federal and provincial governments need to be better coordinated and rationalized.[2] With regard to fiscal policies, the concerns are about how they *interact*:

- In some cases, the various fiscal policies can have an undesirable cumulative effect. For example, the majority of the governments may take an expansionary fiscal stance; if they do so in a completely decentralized and uncoordinated fashion so that each government fails to take account of the others' policies, this could lead to an undesirable degree of fiscal stimulus, which, in turn would lead to inflation and increases in interest rates.
- In other circumstances, the policies can work at cross-purposes. This is the example stressed in the federal government's September 1991 proposals,[3] where it is argued that the Ontario government's fiscal stimulus in the late 1980s served to undermine the fiscal restraint being pursued by the federal government and a number of the other provinces.
- The consistency between fiscal and monetary policies is also an issue. In the example of the above paragraph, it can be argued that the inappropriate stimulus provided by the Ontario government at a time when the Ontario economy was already overheated meant that the Bank of Canada had to opt for higher interest rates and exchange rates than were warranted for the rest of the economy.

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2 This section draws on Douglas Purvis and André Raynauld, "Reconsidering the Federal Proposals for the Economic Union" (Manuscript, 1992). There, we note that while there is strong support for substantial change, they are nevertheless seen, as the proposed changes get stronger — such as the implementation of policy rules — to infringe on the sovereignty of the provinces in this area and support tends to drop.

3 Canada, *Shaping Canada's Future Together* (Ottawa: Supply and Services Canada, 1991).

Thus, it is widely recognized that Canada's economic performance could be improved with better management of the interactions among these various policies. The federal government recognized this in specific proposals in its September 1991 constitutional package. These include:

- the creation of a Council of the Federation to serve as an intergovernmental decisionmaking body, to supplement first ministers' conferences and finance ministers' meetings;
- the development of an annual timetable to allow for more open and visible federal and provincial budgetmaking processes that would include a relatively fixed annual budget cycle, a fixed annual schedule of finance ministers' meetings, publication of prebudget economic and fiscal outlooks, and common accounting conventions; and
- the harmonization of economic policies by developing guidelines for fiscal policies and establishing an independent agency to monitor and evaluate the macroeconomic policies of the federal and provincial governments.

The proposal for a Council of the Federation has received, at best, mixed reviews among specialists and was thoroughly trounced at the constitutional conference held in Calgary in January 1992. Its acceptability has been clouded by the "federal-centric" nature of some of the other proposals for the economic union, as well as by the controversies over Senate reform.

There apparently is strong support for opening up budget processes and establishing a fairly well defined regular budget schedule. One might imagine, for example, a meeting of finance ministers of the Council of the Federation late in the calendar year, at which economic and fiscal forecasts are openly discussed. Some convergence of forecasts might occur, and some sharing of concerns about sources of risk in the forecasts might also transpire. This process would lead naturally to a discussion of the appropriate or feasible policy prescriptions, and in particular to a discussion of how a policy initiative of one government would effect the outlook and the policy decisions of the others.

One might also imagine that the private sector — business and labor — could play a role in this process.

In articulating what policies might be prescribed as a result of this process, it is important to distinguish between medium-term concerns about the cumulative effects of deficits and short-term stabilization concerns directed to more immediate effects on unemployment, growth, and inflation. With regard to the former, there is quite a strong consensus that guidelines for the path of the debt-to-GDP ratio would be constructive. With regard to the latter, there is much less consensus that much should be done beyond opening up the process and sharing information and forecasts. In particular, there is some concern that any attempt to coordinate stabilization policies too precisely leaves the system vulnerable to collective error — that is, vulnerable to the possibility that most or all fiscal policies end up being inappropriate for current business conditions.[4]

This then brings us to the papers by Scarth and Grubel. Each focuses on one of the dimensions of the problem and pays only lip service to the other.

Scarth starts from the proposition that Canada is not an "optimal currency area," in which economic adjustments are smoothly and quickly worked out through changes in prices in goods and factor markets and via factor mobility. By implication, since national monetary policy and federal fiscal policy cannot address these region-specific problems, there is therefore a legitimate need for region-specific stabilization policies, by which Scarth means provincial stabilization polices. He then builds on a simple analytic model that captures the "spillover" effects from provincial fiscal policies — in particular, focusing on how those spillovers are affected by the exchange-rate regime and the fiscal instruments employed.

Scarth attaches considerable importance to whether the spillover is negative or positive — that is, to whether fiscal expansion in,

4 See, for example, Peter Howitt, "Reform of the Bank of Canada and Harmonization of Macroeconomic Policies," and John McCallum, "Economic Aspects of the Federal Proposals," both in R.W. Boadway and D.D. Purvis, eds., *Economic Aspects of the Federal Government's Constitutional Proposals* (Kingston, Ont.: John Deutsch Institute for the Study of Economic Policy, Queen's University, 1991).

say, Ontario has a stimulative or a contractionary effect on Quebec. He refers to the latter as a beggar-thy-neighbor effect, although he recognizes that whether a positive or negative spillover is desirable depends on whether provincial business cycles are positively or negatively correlated.

Besides my concern about the beggar-thy-neighbor terminology, I have some quibbles about other details. For example, Scarth's analysis of the effects of using sales tax cuts rather than government expenditure relies on results that are dependent on the scale variable in the money-demand function, something about which economists' knowledge is not very precise.[5] Further, I would be concerned about how the excessive use of changes in the sales tax rate might affect the tax system's integrity. Overall, however, the analysis seems correct and the results are presented in a clear and balanced way. There is much to be learned from this exercise; indeed, it is impressive how much can be squeezed out of a relatively simple model.

My more major reservations concern what Scarth leaves out. First, I think the message of the spillover effects is that, whatever the sign, they cause the interests of the province in question to diverge from the national interest. If the spillover is beneficial, the province acting in isolation will underutilize its fiscal instrument relative to the national interest since it will not take the beneficial spillover into account. Conversely, if the spillover is harmful, the provincial fiscal instrument will tend to be overutilized relative to the national interest. The important point is not that one case is more desirable than the other, but that either case calls for *coordination*. Coordination in this case does not necessarily mean fine-tuning, but it does mean some negotiating away of the effects of the spillovers; some federal role may be called for, but intergovernmental coordination is the key. I would have thought that this is exactly one area in which the Council of the Federation might be important.

5 In the basic Mundell-Fleming model under flexible exchange rates, there is a one-to-one relationship between the money supply and the scale variable in the money demand function. If this scale variable were disposable income, then government spending would be ineffective, but tax cuts would be effective in terms of influencing GDP.

A full analysis of coordinated provincial fiscal stabilization may prove to be a messy problem. It would include game-theory solutions of strategic behavior, where each government has to take into account the possible reactions of other governments. Further, this issue is complicated by the fact that the structural features of the various economies influence the incentives that governments face in using their policies.[6]

Scarth also identifies a case for considering a fixed exchange rate. Part of this is based on the view that the United States does — and will continue to do — a good job of preserving price stability. Yet, with the United States' persistent record deficits — financed in its own currency — and with a fragile financial sector, I simply do not share Scarth's optimism about the outlook for U.S. inflation. However, there is another ironic dimension of his case for considering a fixed exchange rate that I would like to emphasize. He argues that a fixed exchange rate is most desirable when the provinces are being buffeted by common shocks, so that they experience booms together or slumps together. I would argue that when the provinces experience common conditions, it is usually because the major shock hitting the economy emanates from the monetary authority. This could be monetary excess causing all the provinces to experience inflationary pressures, but this is not typical since monetary excess has usually been a gradual cumulative process so that in many provinces its effects are dominated by other factors, including region-specific terms-of-trade shocks. More likely, it occurs when inflationary pressures have built up to the point where the monetary authority adopts a restrictive anti-inflation policy.

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6 If the recent past is a guide, our interest would have to be directed to noncooperative outcomes, although one possible implication of the present initiatives might be to move toward cooperative solutions. For a discussion of international policy coordination, see Douglas Purvis, "Public Sector Deficits, International Capital Mobility, and the Domestic Economy: The Medium Is the Message" (The 1985 Harold Innis Memorial Lecture), *Canadian Journal of Economics* 18 (November 1985): 423–457. Some simplification relative to that literature might be achieved, since provincial governments do not have the option of using monetary policy.

Hence, Scarth's case for fixed exchange rates — that is, for abandoning monetary policy — applies to situations caused by the active use of monetary policy. One might think that this undermines his case considerably, but there is one situation in which I think his analysis is exactly applicable: when there is a common international need for a restrictive monetary policy, and there is political will abroad to pursue it but insufficient political will domestically. In that situation, foreign monetary restraint will, in the first instance, lead to a weakening of the domestic currency and an increase in domestic inflation; if the monetary authority acts to stabilize the exchange rate, it will then mean than the foreign monetary restraint is mimicked at home.[7] Thus, a fixed exchange rate becomes a vehicle for coordinating monetary policies. While this is an interesting case, I would not like to concede that, in general, Canada's macroeconomic performance would be better enhanced by this kind of international coordination of monetary policy than by improving efforts at intranational coordination of fiscal policies and harmonization of those fiscal policies with national monetary policy.

Part of Scarth's case for the increased use of provincial stabilization policy is the evidence he adduces that provincial fiscal multipliers are larger than conventional wisdom has held them to be. Even in the absence of the spillover issue, this evidence poses the question of the desirable nature of provincial stabilization. Economists like to debate the choice between *laissez-faire* policies and fiscal activism or fine tuning, with the middle-ground compromise of *gross tuning* being a widely held, if imprecise, position. Note, however, that, in fact, many provincial policies have not even been on this spectrum — the procyclical policy of balanced budgets rules out even the *laissez-faire* position of letting the automatic stabilizers operate.[8]

7 In ibid., I argue that this is an apt description of Canadian and European monetary policies during the 1980–81 period.

8 When governments leave their spending and taxation *rules* unchanged, they experience increased net revenues during economic booms and decreased net revenues during slumps. This, in turn, tends to mitigate the booms and slumps that the economy would otherwise experience — thus the term *automatic stabilizer*.

Perhaps a first objective of the fiscal policy reform should be to encourage the provinces at least to let their automatic stabilizers operate. (Note that, by the evidence on the increased fiscal multipliers, the automatic stabilizers have become more effective.)

A major factor tilting many economists toward the automatic stabilizer end of the spectrum and away from the fiscal activism end is that longer-run issues of fiscal prudence can be better safe-guarded at the nonactivist position. Although stabilization over the cycle need not imply accumulation of debt,[9] governments typically have been quicker to inject stimulus during slumps than to withdraw it during booms. As a result, recent business cycles have been associated with a ratcheting up of the debt-to-GDP ratio.

The implications of an increased national debt are the subject of ongoing debate in the economics profession. The Ricardian neutrality hypothesis suggests that increased government debt is offset by increased private saving, so that no decrease in net domestic ownership occurs, and hence no decrease in domestic wealth and standard of living occurs; there is no burden of the debt. The conventional view is that government debt displaces productive assets in private portfolios, thus driving down net national wealth and future national income — this is referred to as the "burden of the debt." Scarth expresses concerns about the national debt and the need for fiscal prudence, but it is not the focus of his paper as it is of Grubel's. Both appear to reject the Ricardian analysis and to accept that increased debt imposes costs on Canadians in the future.[10]

One red herring that must be dispensed with in the debate on the burden of the debt is the "owe-it-to-ourselves" view that the debt is only a burden if it is held by foreigners and hence requires interest payments to be sent abroad. Both Scarth and Grubel appear to give some credence to this view; Scarth in his discussion of the Gramlich

9 I use the term in the growth sense, so debt accumulation means an increase in the debt-to-GDP ratio.

10 Grubel includes a rather enigmatic footnote on the evidence concerning the Ricardian neutrality proposition, but he clearly accepts the burden-of-the-debt view.

analysis and Grubel in a rather convoluted association of it with Keynesian economics.

I believe the owe-it-to-ourselves notion to be wrong and dangerous. In fact, the original analyses of the burden-of-the-debt view were developed in the context of a closed economy.[11] The burden arises when private savers use public debt to transfer income between periods; while these instruments fulfil that purpose for the individual, for the economy as a whole there is debt illusion in that no productive assets are available in the future to generate the national income counterpart to the retirement income that the saver receives. In any event, whether the government debt is held abroad is irrelevant; if national savings are absorbed in part by government debt, then private domestic investment must be financed by borrowing abroad, and the country as a whole still incurs a foreign debt.

Grubel makes clear his concerns about the burden of the debt — including the traditional views about the reduction of living standards — and goes beyond purely economic arguments to suggest that the cumulative impact of deficits is to "deprive Canadians of their economic rights and threaten the stability of the economy and possibly the future of democracy in Canada." They "threaten the very existence of traditional democratic institutions," and reduce welfare by "creating social tensions and threatening personal liberties." These comments set the tone for much of the paper.

There is a great deal of food for thought in Grubel's paper, but many readers will be reluctant to bite. One can forgive Grubel for his sometimes strident and passionate style, given the subject; the fact that he cares deeply about the issue should make his views more interesting rather than less. However, extreme statements such as those cited in the above paragraph, and later references to historical autocratic regimes that censored speech and jailed citizens without trial, seem alarmist and serve to undermine both the author's credibility and his arguments. This is unfortunate, because the paper is

11 Classic papers include those by Peter Diamond and by Franco Modigliani; see the references in Purvis, "Public Sector Deficits."

stimulating and often thoughtful, and the issues are of fundamental importance.

Also off-putting is the unqualified nature of the assertions Grubel uses to present or support his views. For example, wasteful government spending "results from the actions of unconscionable politicians who cater to powerful special-interest groups for the purpose of obtaining their support in upcoming elections," a factor reinforced by "irreversible changes in the technological environment, which have lowered the costs of organization and political lobbying" and by the "fact" that "most modern elections are won by such slim margins that no politician can afford to lose the support of any interest group."[12] If the evidence on the Ricardo effect is regarded as somewhat ambiguous, how strong is the evidence for the costs invoked in the citations in the paragraph above?

Nevertheless, behind his sometimes objectionable rhetoric, Grubel makes a persuasive case for strong measures to control government spending and deficits — although it should be noted that in this regard I am a true believer and hence probably easily persuaded. Grubel uses the evidence presented in the federal government's September 1991 constitutional proposals to provide empirical support for his concerns about trends in spending, taxation, and deficits. The case, of course, is quite strong, although the recent divergence of the experience of the federal government and the consolidated government could have received further discussion, especially with regard to provincial responsibilities for areas — such as health and education — where spending is growing quickly. Furthermore, the provinces' management of the health sector is clearly inhibited by the *Canada Health Act* and by provincial fiscal positions suffering at the hands of reduced federal transfers.

Grubel concludes the review of this evidence on a pessimistic note, arguing that "[n]othing has changed in the political process to make me believe that the combined levels of government will actu-

12 Grubel conveniently ignores the interest groups that have emerged to oppose government spending — as in the national day-care debate — and to fight for lower taxes.

ally achieve smaller overall deficits." This, of course, ignores the limits on spending proposed in the February 1991 federal budget, and the ongoing commitment — confirmed in repeated political commitments made over the past several years in the five-year plans presented with federal budgets — just as it ignores the substantial, though perhaps not yet sufficient, restraint introduced in the past several federal budgets.

More generally, it ignores the political response to the growth in the debt itself — for an economist, it is natural to think of self-correcting mechanisms that work to establish equilibrium levels for key variables. Whether such a process is in place — and whether it equilibrates spending, taxes, or their difference — is of course open to question. But there is some evidence. Pierre Fortin argues that growth in the debt-GDP-ratio will be stabilized as a result of policies put in place in response to concern about deterioration in the government's fiscal position.[13] As I have noted in discussing Fortin's results, "fiscal prudence is self-correcting and capital markets are our friend — the fiscal deterioration in the early part of the decade brought with it the incentives for fiscal correction."[14]

Grubel's pessimism is reinforced by international evidence that he cites supporting the negative relationship between high government spending and economic growth, and by his perspective on the processes in modern industrial economies that bias economic activity toward the public sector. Frankly, I am sympathetic to many of the views put forward here, but I am also pretty sure that if I were not, nothing in Grubel's casual and partial (in both senses) review of the issues would persuade me to change my mind. Grubel appears to use empirical evidence and literature citations the way a drunk would use a lamp post: for support rather than illumination.

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13 Fortin, "Federal Debt Trends in Perspective."

14 Douglas Purvis, "General Discussion," in Prachowny, ed., *Policy Forum on the February 1990 Federal Budget*, p. 79. I go on to argue the bad news that this process works in reverse as well: substantial fiscal correction will create renewed political incentives for increased spending and borrowing.

Grubel's pessimism leads him to the view that some change in the political process is essential; he proposes an economic charter of rights, to parallel the existing Charter of Rights and Freedoms and the emerging support for a social charter. His economic charter involves constitutional constraints on government spending and deficits, with sharp penalties — dissolution of Parliament and an election — for any government that violates them. Grubel argues, not very convincingly, that the provinces would find this more acceptable than the challenge to their sovereignty posed by the federal government's proposals to develop — with the input of the provinces — guidelines to coordinate policies and control the growth of public debt. He also argues — incorrectly, in my view — that his proposals would counter Quebec's concerns about federal fiscal mismanagement while not raising concerns in Quebec about its own fiscal sovereignty.

Given the strength with which Grubel presents his case, his specific proposals appear somewhat disappointing. He is vague about the appropriate level for spending limits, and while he notes the capital-budgeting issue, he gives it only a superficial discussion. He argues for budget balance over the cycle, but without adding substance to the proposition by giving it operational definition. He allows suspension of the limits for an arbitrary period of two years with a super majority, but without justifying the time period or the super majority. He proposes a "rainy day" fund, which appears, however, to be only smoke and mirrors, and he presents no analysis of the stabilization consequences — especially the potential for imposed procyclical fiscal policy — of his limits on the fund. He presents his sanctions with little discussion of the consequences or alternatives. These are hard issues, but I find it impossible to take his proposals seriously in the absence of more concerted attempts to address them.

I find Grubel's message helpful and his ideas stimulating. But his claims for the need and the specifics of his mechanisms are overdone, and the sanctions he imposes are too strong; it seems ironic — and in need of further argument — that in order to save

democracy we have to weaken its central institution: elected Parliament. Frankly, I prefer the government's proposals, as modified below. Combined with the limits on spending proposed in the February 1991 federal budget, I think they will prove to be an effective constraint on spending and deficits while enhancing collaboration between the various governments in Canada.

Prior to reading the Scarth and Grubel papers, my reaction to the debate on the federal proposals for improved economic performance through improved coordination of polices was one of disappointment: not enough attention has been given to the issues of coordination, to the need for mechanisms to limit the growth of the national debt, or to the proposed new institutions. These papers have contributed to the first two issues, but not the last. Yet my instinct is that it is the last one that is important for the constitutional process; the first two are complex issues of economic policy, and perhaps should be dealt with outside the constitutional process.

At this juncture of Canada's history, the issue of *intergovernmental* collaboration is extremely important for future economic performance. The proposed Council of the Federation — perhaps with a related institution, a "Federal-Provincial Commission on the Economic Union," which would be an advisory body of experts — could contribute enormously to improvement of policy performance in this area.[15] I would propose, therefore, that the these institutions be enshrined in the Constitution, with a mandate to improve the harmonization of economic policies. I also endorse the notion that an independent agency be given the mandate to monitor and assess policy in this area on a regular basis. André Raynauld and I have proposed that the federal-provincial commission of experts be given this task, and that its annual report be tabled in Parliament and all provincial legislatures for debate, and that those debates in turn be the basis for open and public discussion at the Council of the Federation.

15 For further discussion, see Robert Howse and Michael J. Trebilcock, "Proposals for the Economic Union and the Division of Powers," in Boadway and Purvis, eds., *Economic Aspects of the Federal Government's Constitutional Proposals*; or Purvis and Raynauld, "Reconsidering the Federal Proposals for the Economic Union."

I believe that, more importantly, these institutions could also contribute to a reversal of recent federal-provincial adversarial relationships and to the evolution of a constructive and positive dynamic built on the spirit of partnership. More than any constitutional limitations on government, that would serve to ensure the living standards and even the democratic rights and freedoms of future Canadians. That is the kind of Canada I want to live in, and that I want my children to inherit.

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Controlling Deficits and Debt in Canada

Herbert G. Grubel, Douglas D. Purvis and William M. Scarth

This volume of "The Canada Round" examines the complex issue of government deficits and debt, which many argue are sapping the country's economic and political vitality.

Herbert G. Grubel calls for tough constitutional limits on the deficits and spending of the federal and provincial governments in order to curb the increasing power of special-interest groups, to protect the rights of Canadians to the fruits of their labor and capital, and to reduce the threat to democracy that arises from excessive spending and deficits. Firm limits would also contribute to national unity, Grubel says, since there is widespread perception in Quebec that federal spending and deficits are out of control.

William M. Scarth argues that when a province increases spending to stimulate its economy — an example of "stabilization" policy — this can lead to higher nationwide interest rates and to a higher Canadian dollar. These, in turn, can have a "beggar-thy-neighbor" effect on the economies of other provinces. He suggests two ways to avoid this problem: fix the value of the Canadian dollar in terms of U.S. dollars, or get the provinces to conduct stabilization policy through temporary changes in sales taxes rather than through changes in spending.

Douglas D. Purvis comments on the essays by Grubel and Scarth. He notes that Ottawa and the provinces need to coordinate fiscal policy, perhaps through the proposed Council of the Federation, but argues that the political process may contain self-correcting mechanisms that come into play when deficits and debt levels become excessive.

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